# CONSENT ORDERS IN SECURITIES REGULATIONS: A REVIEW OF THE SEBI AND SEC MECHANISM

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*Consent Settlement, a universal feature of securities regulatory systems internationally, has recently become a source of debate in both India and the USA. SEBI and the SEC both have faced a series of challenges on similar grounds to their systems, and the differing Constitutional and Administrative Laws of the two nations mirror the differing results of these challenges.*

*While a public interest litigation in the Delhi High Court has successfully galvanized the legal community into increased interest in the mechanism's flaws and ushered in SEBI's May 25th Amendments to its 2007 Circular, the controversial and celebrated order by Judge Rakoff in the Citigroup settlement has been overturned at appeal.*

*The authors of the paper compare the Indian and American systems in the light of their Constitutional and Administrative laws, contextualizing and analyzing the Indian amendment in the light of differing status of*

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*the Judiciaries in matters of judicial review of administrative actions and policy decisions and questions of public interest.*

*While the Amendments in India have indubitably mitigated the lacunae in the system, there are still windows for discretion, which might prove ruinous for the attempt at reform. The paper examines and analyzes these areas of the 2012 amendments and attempts to answer the question that's been pushed to the forefront of the legal community's debates by the recent developments in the Indian and American situations: "Has the Indian Consent Order System Been Saved?"*

## I. CONSENT ORDERS IN INDIA: A PRE 2012 PERSPECTIVE

### *A. Introduction to the 2007 Circular*

Consent settlements have been a persistent theme in commercial laws internationally, appearing in trade[1], investment[2], and financial regulatory[3] systems with a broadly similar concept and system-specific adapted frameworks.

[1]North American Free Trade Agreement, Chapter XIX, U.S.-Can.-Mex., Dec. 17, 1992, 32 I.L.M. 289 (1994).
[2]Convention on the Settlement of Investment Disputes between States and Nationals of Other States,1964, art. 25.
[3]Securities Exchange Board of India, Circular No. EFD/ED/Cir-1/2007 (April 20, 2007).

The consent order system was introduced in India in April 2007 by a circular[4] passed by the Securities Exchange Board of India in exercise of its statutory authority.[5] The circular, which drew inspiration[6] from the Consent Mechanism established by the United States Securities and Exchange Commission (SEC), laid down a system of compounding offences and passing consent orders to settle *prima facie* instances of commission of certain offences.[7]

Paragraphs 8 and 9 of the 2007 Circular established that Consent Orders could be obtained at any stage of a proceeding, from before initial investigations and issuance of a Show Cause Notice to before the final disposal of a civil suit by the apex court, depending only on the gravity of offences to determine whether or not SEBI would insist on fact-finding investigations. A noteworthy aspect of the mechanism in India is that it may involve and admission of guilt[8], and that the range of settlements included barring the accused from trading in securities, along with monetary fines.

The system has been regarded as being in the interest of justice[9] and bringing about a just and equitable resolution of disputes,[10] often approved by the Securities Appellate Tribunal due to its advantages of reduced litigation costs and time[11] and rapid disgorgement to investors and shareholders.[12] Paragraph 11 of the 2007 circular gave

[4]*Id.*
[5]Securities and Exchange Board of India Act, 1992,§§ 15T, 24A Depositories Act, 1996,§§ 22A, 23A; Securities Contracts (Regulation) Act, 1956§23N.
[6]*Supra* note 3, at¶4.
[7]SEBI Act, Sections 11, 11B, 11D, 12(3) and 15I (1992); Equivalent under SCRA (1956) and Depositories Act (1996).
[8]*Supra* note 3, ¶13.
[9]Adani Properties Pvt. Ltd. v. Securities and Exchange Board of India, [2008] 83SCL76SAT; Fincap PortfolioLtd. v. Securities and Exchange Board of India, [2008] 84SCL424SAT.
[10]Ramanlal D. Shah v. Securities and Exchange Board of India, [2008] 83SCL16SAT.
[11]Luminant Investment Pvt. Ltd. v. Amit Pradhan, [2008] 84SCL423SAT.
[12]Godavari Corporation Ltd. v. Securities and Exchange Board of India, [2008] 84SCL385SAT.

certain guidelines to be followed while considering whether to allow or disallow a settlement, of which ground iii. of which reads,

*Gravity of charge i.e. charge like fraud, market manipulation or insider trading*" and ground iv. reads "*History of non-compliance. Good track record of the violator i.e. it had not been found guilty of similar or serious violations in the past*.

However, the application of this circular proved problematic.

### *B. The Lacunae and Flawed Applications of the 2007 Circular*

Increasing numbers of consent orders for grave, market influencing offences were granted after the 2007 circular's introduction. Seemingly indiscriminate granting of settlements in serious offences led to a body of dissent against the mechanism.[13] Even serious violations with market-wide ramifications and harsh implications for investors and shareholders were settled, and repeat offenders were entertained.

In *Securities Exchange Board of India* v. *Prabhu Steel Industries Ltd.*,[14] several serious violations of a grave nature were settled with a consent order, the accused who did not file for a consent order got a ban for 3 months. Especially controversial were the immensely expensive settlements for grave offences, such as the January 2011 Anil Dhirubhai Ambani Group settlement worth rupees 50 crores, Haryana Ship Breakers for 11 Crores and HFCL Group for 10 crores.[15]

Insider trading was settled through consent for Rs. 1 lac by ICICI Bank wherein the bank failed to disclose its major shareholding in

[13]Dinesh Unnikrishnan & Aveek Datta, *Sebi Consent Order System Under Review*, ECONOMIC TIMES, Feb. 20, 2012.
[14]Securities Exchange Board of India v. Prabhu Steel Industries Ltd & Ors.,[2008] 79SCL103 SAT.
[15]Ministry of Corporate Affairs, Government of India (Jul. 2012), www.watchoutinvestors.com.

Jord Engineers thus violating insider trading norms.[16] Other entities that settled serious offences like insider trading, violation of FII Regulations and KYC norms are Indiabulls Securities, Karvy Stock Broking and Centurion Bank of Punjab.[17] The settlement of offences of this grave nature raised many doubts about the application of guideline 11(iii).

Concern was also raised about the seeming disregard of guideline 11(iv), relating to past history with consent orders. More than 136 individuals or companies got 2 or more consent orders, with Action Financial Services obtaining 8 and SMC Global Securities and Systematix Shares & Stocks obtaining 7 each.[18] Consent orders and compounding of offences are not aimed at doing away with lengthy judicial procedure by merely passing an award in exchange of a penalty fees, yet this rampant trend erred on the side of diluting the punishing nature of securities regulation.

These controversial settlements invoked an increasing amount of debate over the soundness of the consent mechanism. As settlements were approved over more serious offences, the scope of the mechanism widened.

A particularly noteworthy expansive interpretation of the mechanism was attempted and ultimately rejected in the *Shilpa Stock Broker cases*. Shilpa Stock Brokers, penalized by SEBI for trading with unregistered Stock Broker and manipulative trades, appealed to the Securities Appellate Tribunal and the Supreme Court, which upheld the penalty in 2005.[19] Shilpa Stock Brokers commenced the procedure for arriving at a consent mechanism during the pendency of the Review proceedings at the Supreme Court.

[16]Reena Zachariah, *Sebi Passes Consent Order on ICICI Bank*, ET BUREAU, May 18, 2012.
[17]*IPO scam: SEBI starts disgorgement process*, TNN, Jun. 6, 2008.
[18]*Id.*
[19]Shilpa Stock Brokers Pvt. Ltd. v. Securities and Exchange Board of India, A.I.R. 2005SC414.

After the Review proceedings were finished and the previous order upheld, the HPAC approved a consent settlement. Shilpa Stock Brokers then moved the High Court of Mumbai under Article 226, seeking to enforce the settlement despite it being passed after complete settlement by the Supreme Court, thereby attempting to expand the scope of the Consent mechanism even further.

However, the High Court held in January 2012[20] that doing so would further blur the already dubious limits of the mechanisms, and that allowing such an expansion would usurp the power of the Supreme Court, which is impermissible.

Industry specialists and experts formed a negative opinion of the mechanism.[21] SEBI's new Chairman, Mr. UK Sinha himself said that he found the system arbitrary in the manner that some serious cases had been settled in the past;[22] other senior officials at SEBI also expressed their consternation over the system's lack of rules to ensure consistency in results and uniformity in penalties.[23] "While in procedural matters, consent is welcome, in other cases (the regulator should not) encourage consent," said C. Achuthan, former president officer of SAT. "Otherwise they (the guilty) will get emboldened to repeat the same. No escape route should be given to market manipulators."[24]

Grave shadows were cast on the credibility of the system with Ex SEBI Board Member, KM Abraham's letter to the PM that he was being pressurized to favourably tackle some high profile cases such as

[20]Shilpa Stock Brokers Pvt. Ltd. v. Securities and Exchange Board of India, A.I.R. 2012Bomb.HC34.

[21]Tina Edwin, *Does SEBI have the Capacity to Deliver Stricter Prosecution or Penalty Regime?*, ET BUREAU (Jun. 3, 2012), http://articles.economictimes.indiatimes.com/2012-06-03/news/31985590_1_consent-orders-insider-trading-settlement-fee.

[22]BS Reporter, *SEBI to Issue Consent Order Norms in Four Weeks*, SMART INVESTOR (Apr. 14, 2012), http://www.smartinvestor.in/market/read-113069-readdet-Sebi_to_issue_consent_order_norms_in_four_weeks.htm.

[23]Dinesh Unnikrishnan & Aveek Datta, *supra* note 13.

[24]*Id.*

those of Sahara, Reliance Industries Limited, ADAG companies, Bank of Rajasthan and MCX-SX, a new stock exchange that currently offers trading facilities in currency derivatives.[25]

### *C. The UBS Securities Case: A Moral Dilemma*

A particularly controversial settlement, The *UBS Securities case* is illustrative to highlight the differing workings Securities regulation and the Consent Order mechanisms pre and post 2012 Amendment is the *UBS Securities case*.

SEBI, in its investigations into the Stock Market Crash of 17/05/2004, had found UBS Securities liable for insider trader, front running, and other very unfair trade practises which contravened Securities Regulations so majorly as to have had a grave detrimental effect on the health of the stock market. Awarding consent orders for such offences would drop the confidence of the investors in the approach of the authorities.

The case was decided by the SAT in 2005,[26] and after the 2007 Circular on Consent Order, it was settled for 50 lac Rupees in 2009 during pendency of appeal to Supreme Court. SEBI drew heavy criticism for this settlement, which is reflective of the change the 2007 circular made. A hypothetical determination of UBS Securities' settlement application after the 2012 amendment would answer several questions regarding the evolution of the Consent Mechanism system in India, and will be attempted at the conclusion of this paper.

### *D. Culmination of the Dissent Against the 2007 Circular*

These problems were serious. Industry opinion on the mechanisms were low, questions were being raised over its transparency, repeat offences by the same individuals and companies, settlement of grave offences that effected investors and general market health, and a

[25]P. Vaidyanathan Iyer, *Ex-SEBI member to PM: ID leaked, Family at Grave Risk*, INDIAN EXPRESS, August 30, 2011.
[26]UBS Securities Asia Ltd v. SEBI, [2005] 6CompLJ64SAT.

creeping attempt to widen the scope of the mechanism too was a source of consternation. The dissent came to head in a Public Interest Litigation filed by a Delhi based entrepreneur named Deepak Khosla at the end of 2011.

Khosla challenged the very power of SEBI to pass such Consent Orders, the validity of the 2007 Circular, and the desirability of the current mechanism. In this, it has been joined by Midas Touch Investors. During the pendency of the PIL, the Amendment to the Consent Oder was passed.

*As the PIL finally ushered in the amendments, call for which had already been brewing, the confidence in the Consent Mechanism was at an all time low. Not only did the Indian Mechanism seem to be failing, the US SEC, which had been a point of inspiration for it, was itself facing a challenge in the shape of Judge Rakoff's rejection of a 280 million USD settlement. It would be illustrative at this point to draw a comparison with the problems faced by the US SEC, before addressing the issue of whether or not, and how far, the amendment is effective at mending the foundations of consent orders in the Indian financial regulatory system.*

## II. CONSENT ORDERS IN THE UNITED STATES OF AMERICA

At the same time as Consent Orders in Securities matters by SEBI were undergoing a period of legal metamorphosis in India, the laws relating to the same mechanism as implemented by the SEC (Securities and Exchange Commission) in the United States were also being challenged by a series of judicial decisions, galvanizing the American legal community into debate over the efficacy of the mechanism and its effect on matters of public interest.

At roughly the same time as the institution of the Deepak Khosla's Public Interest Litigation in the Delhi High Court, Judge Jed Rakoff created waves by turning down a 285 million dollar settlement between the US financial regulator Securities and Exchange Commission and Citigroup.[27] However, March of 2012 brought around somewhat of a turnabout in the case, bringing the matter to a reversal inappeal.[28]

Interestingly, while the grounds of challenge to the Indian and American mechanisms had striking points of similarity, the evaluation and assessment of these grounds, and thus the outcome of the turmoil, are different in India and the United States. These differences reflect upon the inherent dissimilarities in Indian and American Constitutional and Administrative laws. Thus a study of the US episode on Consent Orders brings into light the context, inter-relation and inter-play of Securities Law with the fields of Constitutional and Administrative laws; it also helps put the old and new Indian mechanisms in contradistinction with that of the United States.

### *A. Pre-Citigroup Status of Consent Orders in America*

*a)* <u>*History and Introduction*</u> – The United States is undergoing a phase of debate relating to consent orders, a field of law which has there been settled placidly since the 1970s.

The context to the recent disturbance is that of a uniform period of approval: the United States Supreme Court has on several occasions encouraged the use of consent decrees, citing their meritorious sidestepping of "time, expense, and the inevitable risk of litigation"[29] and recommending them for their role as a stream-lined, rapid mode of settlement.[30] This has naturally led to the gradual lessening of

[27]Dominic Rushe, *Citigroup-SEC settlement rejected by New York judge*, THE GUARDIAN, November 28, 2011.
[28]Jonathan Stempel, *SEC, Citgroup may win appeal in fraud case,* REUTERS, March 15, 2012.
[29]United States v. Armour & Co., 402U.S.673, 681 (1971).
[30]Swift & Co. v. United States, 276U.S.311, 324–27 (1928.

judicial intervention in consent orders; "*unless a consent decree is unfair, inadequate, or unreasonable, it ought to be approved*"[31] became first the pattern, then the formula.[32]

This tone of non-intervention in consent-oriented settlement of offences has, in fact, established a dominant presence horizontally across various laws in the United States.[33] Moreover, the often controversial aspect of non-admission of guilt in consent settlement procedures too has been accepted remarkably readily by the American legal system, both generally in business laws[34] and specifically for securities regulation. In recent times, this trend has strengthened if anything, with serious allegations of anti-trust or competition law violations being settled[35] without admission of guilt[36] as readily as securities law violations. In the 2010 *Vitesse Semiconductor* case involving the Securities and Exchange Commission, this practice was stated as natural and "nothing new".[37]

*b)* <u>*The Goldman Sachs Settlement*</u> – In the same year, the comfortably settled position was once again stirred into debate. In April 2010, the SEC filed a suit against Goldman Sachs for misleading investors with respect to subprime mortgage products, specifically that there was incomplete disclosure of vital information. Goldman Sachs settled the matter by a payment of $550 million, among the largest penalties ever exacted in the then 76 year history of SEC, and also just 1% of Goldman's market value at the time and 2% of its cash balance, leading several to question the efficacy of the procedure as real

[31]SEC v. Randolph, 736F.2d.525, 529 (9th Cir. 1984).
[32]SEC v. Wang, 944F.2d.80, 85 (2d Cir. 1991).
[33] Consent Decrees in Judicial or Administrative Proceedings, Securities Act, 1972.
[34]FTC v. Chembio Diagnostic Sys., Inc., 2001WL34129746, (E.D.N.Y. Jan. 16, 2001).
[35]CFTC v. Kelly, 1998WL1053710, (S.D.N.Y. Nov. 5, 1998).
[36]United States v. Microsoft Corp., 56F.3d 1448, 1461 (D.C. Cir. 1995).
[37]SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 308–10 (S.D.N.Y. 2010).

judicial action and leading a former SEC Commissioner, Paul Atkins to famously remark that he was "embarrassed, as an American".

### *B. Stirring the Nest: The Citigroup Settlement*

*a)* *Introduction to the Citigroup Settlement* – The dissent came to a head with the previously mentioned rejection by Judge Rakoff of the $280 Million settlement with Citigroup over allegations of fraudulent and unfair trade practises including misinformation to investors and shareholders. Judge Rakoff had previously rejected another large settlement with Merril Lynch in 2009, only letting it stand reluctantly.[38] The powerful judgment, which promises to have long-standing ramifications on the subject of consent orders, underlines and emphasizes on several questions that are being raised in India in respect to SEBI's consent order circular and which led to the revised 2012 circular.

*b)* *The Grounds for Refusing the Settlement* – The grounds on which Judge Rakoff has rejected the settlement were primarily:

i. Such a settlement left the shareholders and public with no recourse (as they couldn't litigate on Citigroup's estoppels as the settlement involves no admission of guilt; neither could they litigate on ground of negligence),
ii. It was not just to impose a settlement on Citigroup on mere allegations and without going into the merits,
iii. The opaque procedure merely imposes a small penalty while leaving the public in dark about the real facts of the matter and is thus opposed to public policy

Other grounds raised included that the non-admission of guilt left the court unable to do justice to the aggrieved public, duplicity of positions as Citigroup expressly retained rights to contest the alleged

[38]Peter J. Henning, *Behind Rakoff's rejection of Citigroup settlement*, NEW YORK TIMES, November 28, 2011.

facts in any parallel litigation, and inconsistency with the position adopted in the Goldman Sachs settlement.

The rationale of refusing to allow the Citigroup settlement is better understood when the order is compared with that of the Goldman settlement. Rakoff noted that the Goldman settlement involved a substantially higher civil penalty: a 535 million USD penalty on only 15 million USD in profits, while the Citigroup settlement imposes a 90 million USD penalty on 160 million USD of profits.

Even more significantly, the Goldman case involved an "express admission" from Goldman that its marketing materials and promotion of the securities contained incomplete information, and remedial measures beyond those in the Citigroup agreement.

Returning to the grounds in the judgment, it was reasoned a case of this nature is involved with a matter that has substantial effect on the daily life of American citizens and the economy; that it affects the financial markets "whose gyrations have so depressed our economy and debilitated our lives"[39] and that there was thus an immense call upon the wisdom of the judge to recognize the question of public interest. The court held that in this matter, there was an "overriding public interest"[40] in favor of disclosure and transparency.

In *eBay, Inc.* v. *Merc Exchange,*[41] the US Supreme Court declared, *"According to well-established principles of equity, a plaintiff seeking a permanent injunction ... must demonstrate that the public interest would not be disserved by a permanent injunction",* and that the extraordinary relief of an injunction can be granted in such cases where public interest would be served.

[39]U.S. Secs. and Exch. Comm'n v. Citigroup Global Mkts. Inc., No. 11 Civ. 7 7387, 2011 WL 5903733 (S.D.N.Y. Nov. 28, 2011).
[40]*Id.*, at ¶23.
[41]eBay Inc. v. Merc Exchange, L. L. C, 547 U.S. 388, 391 (2006).

In *Weinberger* v. *Romero-Barcelo,*[42] the court further stated, *"In exercising their discretion, courts should pay particular regard for the public consequences in employing the extraordinary remedy of injunction".* In a similar vein, the Second Circuit Court held in *Salinger* v. *Colting:*[43] *"a court must ensure that the public interests would not be disserved by the issuance of an injunction."*

Thus, the court held that in such a case where public interest was at stake, the court is justified in examining and re-examining the settlement it was to enforce[44] to make sure it was not unfair, unreasonable, or arbitrary, or risk becoming a "*mere handmaiden to a settlement privately negotiated on the basis of unknown facts*."[45]

Having established the above, the court commented that in this instance, the court would be deprived of any assurance that the relief it was asked to uphold had any basis in fact, and the consent order, without any admissions of guilt, amounts only to a modest penalty and is viewed as a *"cost of doing business"* and for maintaining a working relationship with a regulatory agency.

Charging Citigroup only with negligence, while allowing it to settle without admitting or denying to the truth of the charges, despite the right to private civil actions individually for recompense, delivers the shareholders and general public to a Procustean bed, dealing a double blow to any assistance the defrauded investors might seek to derive:[46] they cannot bring securities claims for negligence[47] and also can't derive any relief from estoppels due to the non-admission[48] of SEC allegations by Citigroup.

[42]Weinberger v. Romero-Barcelo, 456 U.S. 305, 312.
[43]Salinger v. Colting,607 F.3d 68, 80 (2d Cir. 2010).
[44]Kokkonen v. Guardian Life Insurance Co., 511U.S.375, 381 (1994).
[45]Dinesh Unnikrishnan & Aveek Datta, *supra* note 13, at ¶24.
[46]*Id.*, at ¶27.
[47]Ernst & Ernst v. Hochfelder, 425U.S.185(1976).
[48]SEC v. Maurice Rind, 991F. 2d 1486, SEC v. Manor Nursing Centers, 458F.2d.1082 (2nd circuit 1972).

In a strongly-worded conclusion, Rakoff observed, *"The Court concludes, regretfully, that the proposed Consent Judgment is neither fair, nor reasonable, nor adequate, nor in the public interest."*

c) *Analysis of Judge Rakoff's Order*

While the order seemed to be a welcome step towards a more accountable financial market and in favour of lessening the opaque nature of the settlement mechanism, the reasoning given therein stands open to several criticisms on closer analysis.

Robert Khuzami, Director of the Division of Enforcement of the U.S. Securities and Exchange Commission, has commented that in the United States the purpose of the consent settlement system is to *"put the public on notice of what laws [the Commission] believe[s] have been violated,"*[49] without necessarily litigating the claims through final judgment.

The court cited cases where the importance of an untrammelled consent settlement system had been underline, such as *SEC* v. *Clifton*[50], where it had been held that an agency capable of settling enforcement actions conserves resources- both its own and that of the courts. In *Heckler v. Chaney*[51] it was added: the agency should consider:

*Whether a violation has occurred, but whether agency resources are best spent on this violation or another, whether the agency is likely to succeed if it acts, whether the particular enforcement action requested best fits the agency's overall policies, and, indeed, whether the agency has enough resources to undertake the action at all.*

[49]Robert Khuzami, *Remarks Before the Consumer Federation of America's Financial Service Conference* (Dec. 1, 2011), http://www.sec.gov/news/speech/2011/spch120111rk.htm.
[50]SEC v. Clifton, 700 F.2d 744, 748 (D.C. Cir. 1983).
[51]Heckler v. Chaney, 470 U.S. 821, 831 (1985).

As for the question of public interest, in *Citizens for a Better Environment* v. *Gorsuch,*[52] it was given that *"Not only the parties, but the general public as well, benefit from the saving of time and money that results from the voluntary settlement of litigation".* The public was said to benefit from the non-reliance on the taxing, drawn out process of court actions.

The ground of public interest for declining to entertain the settlement order was held untenable, noting that there exist grave constitutional difficulties in judicial review of consent judgments on ground of public review.[53] Neither of the leading cases on the same issue, *Winter* v. *Natural Resources Defense Council, Inc.*[54] or *eBay, Inc.* v. *Merc Exchange,*[55] support the reasoning given by Judge Rakoff.

In *Carson* v. *Am. Brands, Inc.,*[56] it was recognized that by disallowing the enforcement of a mutually agreeable settlement, the District Court effectively ordered the parties thereto to undergo trial by court to determine their rights and liabilities, foregoing their own settlement of the same.

*d) <u>The Appeal from Judge Rakoff's Order</u>*

The decision from Judge Rakoff was reversed in appeal.[57] The appellate court found the judgment mired with legal difficulties that could not be reconciled with the reasoning given, and chose to reverse the order on these problems while not commenting on the larger overarching theme of judicial dissatisfaction with the implementation of the consent order system.

Some of the strongest grounds for reversing the order were that the division of responsibilities between the executive and the judiciary

[52]Environment v. Gorsuch, 718 F.2d 1117, 1126 (D.C. Cir. 1983).
[53]United States v. Microsoft Corp., 56F.3d.1448, 1461 (D.C. Cir. 1995).
[54]Winter v. Natural Resources Defense Council, *Inc*555 U.S. 7, 24 (2008).
[55]Winter v. Natural Resources Defense Council, *Inc*547 U.S. 388, 391 (2006).
[56]eBay, Inc. v. Merc Exchange, 450 U.S. 79, 87 (1981).
[57]U.S. Secs. & Exch. Comm'n v. Citigroup Global Markets Inc. 11-5227-cv (L).

did not permit a federal court to disregard policy decisions of an executive agency, especially in regard to matters such as whether or not these policies serve the public interest, and the agency's expenditure or use of resources. The authority of a court to refuse a private party's decision to settle a dispute, merely because the court is not convinced about the liability of the parties was also called in question.

The first ground for the reversed decision was that S.E.C.'s decision to settle with Citigroup disserved the public interest and was bad policy. However, in the United States, it is not a proper function of federal courts to decide policy for the executive.[58] This position of law was established beyond doubt in *Chevron, U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*[59]

In *Motor Vehicle Mfrs. Association of U.S., Inc.* v. *State Farm Mut. Auto. Ins. Co.*[60] it was stated that in reviewing whether agency action is arbitrary, *"a court is not to substitute its judgment for that of the agency".* While a court does have some scope of review over an agency decision to settle,[61] the scope of a court's authority to *"second-guess an agency's discretionary and policy-based decision to settle is at best minimal"*.[62] Thus the court was mistaken in not giving the obligatory deference to the S.E.C.'s policy in relation to public interest.

The second reasoning adopted by the court was that the settlement was unfair to Citigroup, as it imposed *"substantial relief on the basis of mere allegations"*,[63] which are *"neither proven nor*

[58]TVA v. Hill, 437U.S.153, 195 (1978).
[59]U.S.A., Inc. v. Natural Resources Defense Council, Inc, 467 U.S. 837, 6 866 (1984).
[60]Motor Vehicle Mfrs. Association of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.,463 U.S. 29, 43 (1983).
[61]New York State Dep't of Law v. F.C.C., 984 F.2d 1209.
[62]Ass'n of Irritated Residents v. E.P.A., 494F.3d1027, 1031- 33 (D.C. Cir. 2007).
[63]U.S. Secs. and Exch. Comm'n v. Citigroup Global Mkts. Inc., No. 11 Civ. 7 7387, 2011 WL 5903733, at (S.D.N.Y. Nov. 28, 2011).

*acknowledged"*.[64] It is not, however, any court's concern to *"protect a private, sophisticated, counseled litigant from a settlement to which it freely consents".* The discretion possessed by the court does not extend to refusing a litigant reaching a voluntary settlement.[65]

In allowing the reversal of Rakoff's order, no "irreparable harm" would be caused, yet both S.E.C. and Citigroup will suffer significant harm if the settlement of their dispute is set side and a trial is ordered. Despite authorities to the effect that refusing a settlement[66] is not "irreparable harm",[67] the balance of utilities in this case is in favor of allowing the settlement to subsist.

The final factor to be considered is the public interest. The court is bound to give deference[68] to an executive agency's assessment of public interest, and the S.E.C. has asserted that public interest is served by the settlement agreement. In *Chevron*,[69] the court stated: *"The responsibilities for resolving the struggle between competing views of the public interest are not judicial ones, the Constitution vests such responsibilities in the political branches."* A similar decision was reached in *Publicker Indus. Inc.* v. *United States (In re Cuyahoga Equipment Corp.,*[70] where it was given that *"courts ordinarily defer to the agency's expertise and the voluntary agreement of the parties in proposing the settlement."*

### *C. Conclusion to the US SEC Consent Order Debate*

It is undeniable that the stability of the long-settled position of law from the era of *SEC* v. *Randolph* and *SEC* v. *Wang*, eroded continuously by a growing tenor of dissent in judicial opinions as

[64]*Id.*
[65]Cf. Janus Films, Inc. v. Miller 801F.2d.578, 582 (2d Cir. 1986).
[66]State of New York v. Dairylea Coop., Inc., 698F.2d.567, 570 (2d Cir. 1983).
[67]Grant v. Local638, 373 F.3d 104.
[68]*Supra* note 58.
[69]Chevron U.S.A., Inc. v. NRDC, 467 U.S. 837 (1984).
[70]Publicker Indus. Inc. v. United States (In re Cuyahoga Equipment Corp., 980 F.2d 110, 118 (2d Cir. 1992).

seen in the Goldman Sachs and Merril Lynch settlements, has been thoroughly disrupted by Judge Rakoff's decision in *SEC* v. *Citigroup Global Markets*.

However, the lasting impact of the order is questionable. While it subsists strongly as an exemplar of the growing concerns regarding the transparency, public interest, and effect on shareholder rights and general rule of law of the Consent Order mechanism, it has failed as an actual standing judgment.

Most fascinatingly for Indian scholars and jurists, this failure, brought about a reversal on appeal, is rooted on grounds of the order's incongruence with American Constitutional and Administrative laws. The order was refused as in the United States,

1. The judiciary must give deference to an executive agency's assessment of the suitability of its allocation and use of resources,
2. An executive agency's assessment of public interest cannot be challenged by the judiciary unless its creates a manifestly absurd position,
3. The scope of judicial review of an executive agency's policy decisions is severely limited.

In India, the situation is radically different:

1. The Separation of Powers ingrained in the Basic Structure of the Indian Constitution gives the Judiciary a scope unrestricted by the executive,
2. The judiciary is free to question policy decisions subject to certain caveats,
3. The Supreme Court is the final interpreter of legislations and thus can determine "public interest" with finality, using it to conclude debates over legislations in a manner most suited to the rule of law and India's status of a social welfare state

Thus, the common problems with the Indian and American consent mechanism, that of lack of transparency, the mechanism becoming a

route of easy settlement or a cost of doing business and thus diluting the deterrent effect of securities regulation, and the dubious effect on public interest in general and investor/shareholder rights in specific, led to different conclusions.

While hope for reform still lies in the US SEC Consent Order mechanism's future due to the recent judicial challenges; India has, after the series of contested and controversial settlements, the cases questioning the mechanism and culminating in the PIL filed by Mr. Khosla, revised its mechanism effectively and officially.

What remains to be seen is the efficacy of the new Indian Consent Order mechanism.

## III. THE 2012 AMENDMENT TO SEBI'S CONSENT ORDER CIRCULAR

### *A. Key Features of the Amendment*

The SEBI's amendments to the consent procedure were labeled a "partial modification"[71] intended to "provide more clarity on… scope and applicability".[72]

The most striking element of the new system is included in the very first paragraph: certain offences have been exempted from the mechanism and can no longer be settled. These exemptions include insider trading,[73] front-running,[74] fraudulent trade practices with market-wide implications and substantial effect on investor rights.[75]

The importance of this amendment is not to be understated. The ramifications of such violations have been recognized in several

[71]Circular No. EFD/1/2012 (May 25, 2012), http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337946507938.pdf.
[72]*Id.*
[73]S*upra* note 70, at¶1(i).
[74]S*upra* note 70, at¶1(iv).
[75]S*upra* note 70, at ¶1(ii).

cases.[76] In *Rakesh Agarwal* v. *Securities Exchange Board of India*,[77] it was given that "inequitable and unfair trade practice such as insider trading affect the integrity and fairness of the securities market and impairs the confidence of the investors". Healthy growth and development of securities market depends on the quality and integrity of a market, which can inspire confidence in investors. The factors on which this confidence depends include that they are placed on an equal footing and will be protected against improper use of inside information.

In *Securities Exchange Board of India* v. *Shri Samir C. Arora*,[78] the court held that participation in the securities market by persons who have committed offences of that degree of gravity would be *"prejudicial to the interests of the investors and the safety and integrity of the securities market".*

Lord Lane has commented on such unfair trade practises, stating,

*It is an obvious and understandable concern...about the damage to public confidence which insider dealing is likely to cause and the clear intention to prevent so far as possible what amounts to cheating when those with inside knowledge use that knowledge to make a profit in their dealing with others*.[79]

Thus the exemption from consent proceedings of these offences is a step in keeping with the judicial opinion on the desirability of prosecuting them to ensure a healthier and more robust market.

The most striking feature of the new amended circular is Annexure A which lays down guidelines for determining the criteria on which consent settlements shall be carried out. This arrangement is aimed at

[76]Hindustan Lever Ltd. v. SEBI, [1998] 3CompLJ 473.
[77]Rakesh Agarwal v. Securities Exchange Board of India [2004] 1 Comp LJ 193 SAT.
[78]Securities Exchange Board of India v. Shri Samir C. Arora, [2002] 38 SCL 422.
[79]Attorney General's Reference No.1 of 1988 (1988) BCC 765, affirmed by the House of Lords at (1989) BCC 625.

eliminating ambiguity and inconsistency in the manner in which consent settlements were done. The new model also puts in certain amount of pressure on the HPAC to expeditiously dispose consent application within a period of at least 6 months.[80] The previous model did not stress upon this aspect. However this time stipulation is merely suggestive and not mandatory.

Another bold reform ushered in by the amendment is aimed at curbing the practise of repeat offenders trying to settle cases without admitting guilt. It disallows settlement of more than two violations every three years, further restricting settlements to not more than one settlement in 2 years. The new model thus prescribes a cooling off period for all violations so that the mechanism is not misused or treated, as Judge Rakoff termed it, as a modest cost of doing business.

Perhaps one of the most significant changes is the radical increase in transparency of the procedure; certain orders before the amendment had been criticized as being difficult to reconcile with the stated guidelines. The High Powered Advisory Committee and the panel of two Whole Time Members are now required to elaborate on the provisions of law being violated, the alleged misconduct, and facts and circumstances.

### *B. Constitutional and Administrative Law Perspectives on the Amendments*

These changes touch upon the power of judicial review of administrative and executive actions, which have been interpreted in the celebrated case of *Minerva Mills:*[81]

*The power of the judicial review is an integral part of our constitutional system and without it, there will be no Government of*

[80]Circular No. EFD/1/2012 (May 25, 2012), http://www.sebi.gov.in/cms/sebi_data/attachdocs/1337946507938.pdf.
[81]Minerva Mills Ltd. & Ors vs Union Of India & Ors., 1980 A.I.R. 1789.

*Laws and the rule of law would become a teasing illusion and a promise of unreality.*

Further, it was held that "if there is one feature of our Constitution which, more than any other, is basic and fundamental to the maintenance of democracy and the rule of law, it is the power of judicial review; it is unquestionably a part of the basic structure of the Constitution".

While the scales of reference in the *Miverva Mills case* and the present scenario are indubitably different, the underlying theme of Constitutionalism is common: it is the submission of the authors that it abrogates from the power of judicial review and rule of law is massive violations affecting the entire market and the rights is several private individuals are settled not once but several times in a manner that is opaque and flawed.

The changes brought about by the amendment are also in keeping with the theme of Indian administrative law, which has been established by a series of judicial pronouncements starting from the *In Re Delhi Laws Act case:*[82] prohibition of unchecked administrative discretion[83] which does not adhere to the guiding principles.[84] Before these amendments, Consent Orders were granted freely contravening the guiding principles given in Para 11 of the 2007 Circular: it was impossible to reconcile such exercise of discretion with the principles of natural justice and administrative law.

Furthermore, the authors submit that the granting of consent orders in manners as questionable as 8 times to a single offender, and without a recording of reasons, clearly is not made by application of mind: these factors establish it as mechanical exercise of discretion[85] and bad in

[82]In Re Delhi Laws Act case, 1951 A.vI.R. 332.
[83]Bangalore Medical trust v. B S Mundappa, 1991A.I.R. 1902.
[84]Magganlal Chagganlal Ltd. v. Municpal Corporation of Greater Bombay, 1974A.I.R. 2009.
[85]Anil Kumar v. Union of India,[2007] 2SLJ63CAT.

law.[86] The strict restrictions placed upon such practise by the amendments are thus a very necessary measure.

### *C. UBS Securities under the New Regime: An Analysis*

Revisiting *UBS Securities*, it is useful to hypothesize the result if the case had occurred after the 2012 amendment. The case arose from the Stock Market Crash, after which SEBI investigated into several persons and institutions to determine the causes of the crash. Out of the violations it unearthed, the ones by UBS Securities Asia had been some of the gravest- insider trader, front running, other unfair trade practises had been carried out. Before the case could be disposed off finally by the judiciary, the 2007 circular was passed and a consent order was granted to UBS for a sum of 50 lacs, which drew immense criticisms for the relatively low monetary settlement and the fact that such offenses had been settled at all.

Supposing the consent settlement application for a similar incident had been made today, it would not be eligible for the settlement procedure at all. Offenses of such gravity and negative ramifications have been excluded from the scope of the circular. However, a provision still exists in the amendment to grant SEBI discretion to consider a consent application.[87]

This discretion clause, while it may seem a self-defeating inclusion in an amendment which aims to eradicate settlement of grave violations, is only as controversial as its application. While the question does arise: what "facts and circumstances of the case" could arise that would make settlement of insider trading an act in public interest or in keeping with SEBI's goals relating to investor protection? The escape clause also seems at odds with the special emphasis provided

[86]Ram Lal Sharma v. Union of India, [2007] 1SLJ59CAT.

[87] *"Notwithstanding anything contained in this circular, based on the facts and circumstances of the case, the HPAC/Panel of WTMs may settle any of the defaults listed above"; supra* note 80, at ¶ 1.

by italicizing the words "shall not", in "SEBI *shall not* settle the disputes listed below".

The decisive question thus is: will the HPAC or a panel of Whole Time Members exercise this discretion? Perhaps the most suitable authority on this question would be Sandeep Parekh, the Executive Director of SEBI at the time of the passing on the 2007 circular and by whose signature it had been passed, who states: *"the prohibition of cases like insider trading cases which are usually barred from being settled is likely to be the rule. Few will exercise discretion where the broad rule is to not allow it",*[88] further adding that he expects the exercise of this discretion to not be more often than "once or twice a year".

Administrative law today does not embrace Dicey's strongly negative view of administrative discretion, yet it cannot be denied that this clause is dubious at best. If the general themes of the amendments are abided by though, a *UBS Securities* settlement would be impossible today.

### *D. Critical Analysis of the Amended Consent Order Mechanism*

Over the course of the paper, the history of consent orders in India has been traced from pre 2007 and post 2007 times, analyzing the various issues with the system at that point to 2012 and the amendments.

The lack of transparency, repeated violations being settled, settlement of grave offenses, absence of a clear and consistent standard for denial or acceptance of consent applications, and the non-abeyance of the guidelines encapsulated in the circular led to discontent with the working of the system. The note of dissent reverberating between industry experts and the Securities Appellate Tribunal grew into a crescendo as a Public Interest Litigation was filed by entrepreneur Deepak Khosla challenging the capacity to pass such a circular.

[88]Sandeep Parekh, *Amendments to SEBI Consent Order Provisions are welcome*, ECONOMIC TIMES, May 29, 2012.

The amendments have indubitably been very thorough in their attempt to dispel industry concerns and plug the loopholes in the system. The increased levels of transparency, limitations on the number of consent order obtainable in a set period of time and measures at expediting the speediness of the system are effective, comprehensive, and welcome.

However, what might be the most crucial change of all is marred by the presence of a discretion clause oddly incongruous with the objective and tone of the amendments. The exclusion of more serious offences is a step worded in strong emphasis, as in needed in a change so crucial. Yet there has been provided discretion to SEBI to entertain them anyhow, without any very specific guidance being provided to this discretion beyond the need to "consider" the "facts and circumstances". It is difficult to imagine any situation in which the public interest would be served or the securities market be better regulated by settling grave offenses which threaten investor rights and the health of the market.

Poorly guided discretion might crack the otherwise appreciable new circular, though securities regulation experts believe that a general rule has been established firmly enough to dissuade the exercise of this discretion very often.

## IV. CONCLUSION

SEBI has acted at a time when the securities regulation system that inspired the consent mechanism in the first place is still unable to resolve the issues, despite Judge Rakoff's refusal of the Citigroup settlement.

Constitutional differences place the American judiciary in a radically different position as concerns the matters of judicial review, public interest and executive policy. However, the authors assert that the seeds of change having been sown, the American system is very

likely to change to a significant degree; the overruling of Judge Rakoff's order does not spell the end of the dissent against the consent mechanism.

The new amendments have increased the scope of judicial review of the administrative acts of granting settlements and consequently made the misuse of administrative discretion less likely. This is a laudable development and an achievement for our constitutionality, judiciary, law-makers and the executive.

The authors conclude by observing: the amendment is sure to increase investor confidence, make the securities market more robust and do away with the growing trend of manipulative trade practises by big players; yet it cannot be called self-sufficient in its role as change-bringer due to the windows still open for discretion. It will take a proactive judiciary and wise exercise of discretion by SEBI's officials to ensure that the note of triumph in our resolution of the consent order problem sustains and is an exemplar to securities markets worldwide.