CEASE THE DEMAT FREEZE! PASSIVE PROMOTERS CAUGHT IN THE CROSSFIRE OF REGULATORY ACTIONS

by

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INTRODUCTION

The Securities Exchange Board of India ("SEBI"), through its robust and dynamic regulatory framework, has fuelled the market capitalisation of listed companies in India to over 5 trillion mark.[1] This surge in the market capitalisation of Indian equities has catapulted India's position as the world's fourth largest equity market.[2] Taking advantage of the favourable market conditions and strong economic growth environment, numerous companies have lined up to partake in the IPO boom. In the first three quarters of FY 2024, India has recorded 260 IPO listings, with a total deal value of USD 9.4 billion.[3]

While stock market listing brings with it numerous advantages such as additional capital for company's growth, increased visibility and credibility, liquidity and ready marketability of securities. However, it is not all sunshine and rainbows, as listing brings with it increased regulatory scrutiny. More importantly, upon listing, the corporate entity is obligated to ensure compliance with stringent provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("LODR Regulations").

The LODR Regulations are designed to ensure transparency, protect investors, and promote fair competition. The Regulations mandate listed entities to adhere to a wide range of compliance norms, including timely disclosure of material events, maintaining minimum public shareholding, financial reporting obligations and ensure robust corporate governance practices.

The relevant recognised stock exchanges, being first level regulators, regulating companies listed on the exchange, are required to monitor compliance by the listed entity with the provisions of the LODR Regulations. The exchanges are also required to monitor adequacy/accuracy of the disclosures made by the listed entity.[4] Failure to comply with these requirements can attract a spectrum of penalties, ranging from fines to more stringent measures such as freezing of demat accounts of promoters of

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1 Nikhil Agarwal, "India's market-cap crosses $5-trillion milestone", (m.economictimes.com, 22-5-2024).

2 Mayank Patwardhan, "India reclaims fourth biggest Global Equity Market Tag from Hong Kong", (business-standard.com, 14-6-2024).

3 George Chan, "How can you shape your IPO with confidence?", (ey.com, 25-9-2024).

4 SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Regn. 97.

defaulting entity[5] as well as compulsory delisting of defaulting entity on account of continued non-compliance for a period of 6 months[6].

Upon compulsory delisting, the wholetime Directors, the person(s) responsible for ensuring compliance with the securities laws and promoter/promoter group, of such defaulting entity shall also incur debarment from: (*i*) accessing capital market by SEBI and/or (*ii*) seeking listing of equity shares and/or (*iii*) acting as intermediary in security market, for a period of 10 years from the date of delisting.[7] Owing to the disqualification incurred by such promoter/promoter group members of the delisted entity, the other unlisted issuer entity/entities (promoted by such persons or associated with such person(s) in the capacity as promoter/promoter group), is also not eligible to make a public offer.

In terms of Regulations 97, 98 and 99 of the LODR Regulations read with SEBI Circular dated 22-1-2020 ("2020 Circular")[8], the relevant stock exchanges, in coordination with the depositories, are empowered to take action against listed entities and their promoter/promoter group in case of non-compliance with the LODR Regulations, by levying fines, freezing promoter/promoter group holdings, suspension of trading in the shares of the non-compliant listed entity, compulsory delisting of securities, etc.

The said 2020 Circular, issued in aid of the LODR Regulations, sets out standard operating procedure ("SOP") to be followed by stock exchanges for non-compliance of the LODR Regulations by listed companies. In terms of the 2020 Circular, if a listed entity continues to be non-compliant with certain provisions of the LODR Regulations, notices are sent to the listed entity in the first instance and thereafter to its promoter(s)/promoter group[9] to rectify the non-compliances and ensure payment of fines by the defaulting entity. In case of continuing non-compliance and/or non-payment of fines, the stock exchange shall suspend the trading in the shares of a non-compliant listed entity and thereafter the demat account(s) of the promoter/promoter group are frozen till non-compliances are rectified and fine is paid[10]. Pertinently, in addition to the

5 SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Regn. 98.

6 SEBI Circular, Clarification on applicability of Regulation 40(1) of SEBI (Listing Obligations and Disclosure Requirements), 2015 to open offers, buybacks and delisting of securities of listed entities, SEBI/HO/CFD/CMD1/CIR/P/2020/144, (issued on 31-7-2020), Para 4.

7 SEBI (Delisting of Equity Shares) Regulations, 2021, Regn. 34.

8 SEBI Circular, Non-compliance with certain provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 and the Standard Operating Procedure for suspension and revocation of trading of specified securities, SEBI/HO/CFD/CMD/CIR/P/2020/12 (issued on 31-7-2020).

9 SEBI Circular, Non-compliance with certain provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 and the Standard Operating Procedure for suspension and revocation of trading of specified securities, SEBI/HO/CFD/CMD/CIR/P/2020/12 (issued on 31-7-2020), Annexure I, Para 5.

10 SEBI Circular, Non-compliance with certain provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 and the Standard Operating Procedure for

freeze of the shares of the promoter/promoter group in the non-compliant listed entity, the holdings in the demat accounts of the promoter/promoter group in other securities is also liable to be frozen during the period of suspension.[11] Freezing of promoter/promoter group demat accounts, is a temporary measure, which is intended to nudge the defaulting entities to ensure compliance of the disclosure requirements.[12]

This enforcement mechanism, although well intentioned, ensures that the responsibility to ensure compliance and/or payment of fines by the listed entity is solely affixed on the promoters of the defaulting entity (and not on the Managing Director/Wholetime Director/Chief Executive Officer) and restricts their ability to trade or access their demat holdings until the non-compliances are rectified. However, the LODR Regulations and the 2020 Circular fail to distinguish between promoters exercising control over the company/promoters who are majority shareholder in a company and named promoters with no involvement in affairs of the company/promoters holding nominal shares in a company ("passive promoters") and hence are not in a position to ensure compliance and/or payment of fines by the defaulting entity. Therefore, freezing of demat accounts of such passive promoters comes across as a punitive measure which is arbitrary and disproportionate causing prejudice to the interest of such passive promoters who are not even at the helm of company's affairs. Hence, there is a need to revisit the LODR Regulations in order to strike a balance between individual accountability for continuing non-compliance and/or non-payment of fines by the listed entity vis-à-vis practical considerations.

The constitutionality of Regulations 97, 98 and 99 of the LODR Regulations and the SEBI Circulars dated 7-9-2016[13], 26-10-2016[14] ("2016 Circular") and 30-11-2015[15] are currently subject-matter of challenge before

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(footnote 10 *contd.*)

suspension and revocation of trading of specified securities, SEBI/HO/CFD/CMD/CIR/P/2020/12 (issued on 31-7-2020), Annexure I, Para 6.

11 SEBI Circular, Non-compliance with certain provisions of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 and the Standard Operating Procedure for suspension and revocation of trading of specified securities, SEBI/HO/CFD/CMD/CIR/P/2020/12 (issued on 31-7-2020), Annexure II, Para B(*iii*).

12 *Manisha B. Kadhi* v. *SEBI*, 2020 SCC OnLine SAT 237.

13 SEBI Circular, Restrictions on Promoters and Whole-Time Directors of Compulsorily Delisted Companies Pending Fulfillment of Exit Offers to the Shareholders, SEBI/HO/CFD/DCR/CIR/P/2016/81, (issued on 7-9-2016).

14 SEBI, Circular, Freezing of Promoter and Promoter Group Demat accounts for non-compliance with Certain Provisions of Listing Regulations, SEBI/HO/CFD/CMD/CIR/P/2016/116, (issued on 26-1-2016).

15 SEBI, Circular, Non-compliance with certain provisions of Listing Regulations and Standard Operating Procedure for suspension and revocation of trading of specified securities, CIR/CFD/CMD/12/2015, (issued on 30-11-2015).

the Bombay High Court in *Pradeep Mehta* v. *Union of India*[16] ("*Pradeep Mehta case*") which is dealt with in detail in Section III of this article.

PERILS OF BEING A PROMOTER OF A LISTED ENTITY

Over two-thirds of corporate structures in India is family owned and promoter centric.[17] Family-owned companies constitute 75% of Indian stock exchanges market capitalisation.[18] Accordingly, the Indian securities law is focussed on holding the promoters/promoter group accountable for the lapses on part of the company. A promoter plays a vital role in raising of capital for a company and the public invests at the behest of the promoter, therefore, the role of a promoter is subject to greater scrutiny irrespective of their shareholding and/or position in the management of the company.[14] Promoters are seen as key figures in the company's governance and financial health, and their influence is presumed to extend even beyond their direct involvement. Hence, promoters who continue to flout the bye-laws, rules of the stock exchange and the LODR Regulations are required to be held accountable for lapses on part of the listed entity, this is to primarily to protect the interest of the investors/shareholders of the company.

Definition of Promoter

Under the Indian securities law, a person is categorised as a promoter if:

(*a*) he has been named as such in a prospectus/draft offer document[19]/ offer document or is identified by the company in the annual return[20]; or

(*b*) he has control over the affairs of the company, directly or indirectly whether as a shareholder, Director or otherwise[21]; or

(*c*) he is a person in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act[22]:

The above definition of the term promoter includes wide array of persons, who go beyond persons who are in actual and effective control of the company. The definition is wide enough to include shareholders who once held a controlling stake at the time of listing, who were classified as promoters. However, post listing, these shareholders were diluted to a minority stake with

16 2024 SCC OnLine Bom 2771.
17 "Corporate governance 2023 — India" Global Practice guides. (https://practiceguides.chambers.com, March, 2024).
18 "Beyond governance why promoter-led businesses need to address fraud, misconduct, and non-compliance" (deloitte.com).
14 SEBI, Circular, Freezing of Promoter and Promoter Group Demat accounts for non-compliance with Certain Provisions of Listing Regulations, SEBI/HO/CFD/CMD/CIR/P/2016/116, (issued on 26-1-2016).
19 SEBI (Issue of Capital and Disclosure Requirements) Regulations, Regn. 2(1)(*oo*).
20 Companies Act, S. 2(69)(*a*).
21 Companies Act, S. 2(69)(*b*).
22 Companies Act, S. 2(69)(*c*).

no controlling rights. While such shareholders are no longer able to exercise any control over the company, they often continue to be classified as promoters due to the disclosures made in the offer documents at the time of company's incorporation and are accordingly liable for non-compliances by the company/ listed entity.

Definition of Promoter Group

Further, the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("the ICDR Regulations") includes a wide array of individuals/entities that, due to their proximity with the promoter, can be termed as interested parties. Such interested parties may not even have any shareholding in the company, let alone having any control.

The definition of the term "promoter group" in terms of Regulation 2(1)(*zb*) of ICDR Regulations includes:

(*a*) promoter;

(*b*) promoters' immediate relatives (such as a spouse, parents, siblings, or children);

(*c*) all persons whose shareholding is aggregated under the 'shareholding of promoter group' category;

(*d*) any body corporate in which 20% or more of the equity shares are held by the promoter or an immediate relative of the promoter, or a Hindu Undivided Family in which the promoter or any one or more of their relative is a member or a firm;

(*e*) any body corporate in which a body corporate entity defined in (*d*) above holds 20% or more equity shares;

However, financial institutions, banks, foreign portfolio investors (excluding individuals, corporate bodies and family offices), mutual funds, venture capital funds, alternative investment funds, foreign venture capital investors, and insurance companies are not considered part of the promoter group solely due to holding 20% or more of the promoter's equity, unless for the subsidiaries or companies promoted by them or mutual funds sponsored by them.[23]

Obligations and Liabilities of Promoter/Promoter Group

The position of promoter/promoter group in a listed entity seems to have been summed up in the words of Shakespeare — "*uneasy lies the head that wears a crown*". The current legal and regulatory regime, imposes significant liability on such controlling heads who run these entities for several types of regulatory non-compliances:

(*a*) Companies Act, 2013: The promoter is liable for misrepresentation or untrue statements in the prospectus and can be held accountable for

23 SEBI (Issue of Capital and Disclosure Requirements) Regulations, Regn. 2(1)(*pp*).

damages to investors for any losses caused by such inaccuracies.[24] After incorporation, promoters remain liable for untrue or misleading statements in the prospectus and can be held accountable for damages to investors due to misrepresentation.[25]

(*b*) ICDR Regulations: The promoter must ensure transparent and accurate disclosures during the issue of securities,[26] disclose shareholding under the Takeover Regulations,[27] and maintain a minimum contribution of 20% in the company's post-issue capital for at least three years.[28]

(*c*) LODR Regulations: The promoter is mandated to ensure compliance with corporate governance norms, timely disclosures and financial reporting. The promoter of the listed entity shall fulfil responsibility and ensure that the listed entity complies with the obligations under the LODR Regulations.[29] Penalties are imposed on listed entities or any person contravening its provisions, including fines, suspension of trading, freezing of promoter or promoter group holdings of designated securities, and other actions specified by SEBI.[30]

(*d*) SEBI (Delisting of Equity Shares) Regulations, 2021 ("the Delisting Regulations"): The Delisting Regulations mandates compulsory delisting for procedural or compliance lapses, such as non-payment of listing fees or unfair trade practices.[31] Upon delisting, promoter must buy back public shareholders' shares at a fair value within three months.[32] Furthermore, wholetime Directors, promoters, and associated companies of a delisted entity are barred from accessing the securities market or acting as intermediaries for ten years.[33] Pursuant to the Delisting Regulations, SEBI issued a Circular dated 7-9-2016 on "Restrictions on Promoters and Whole-Time Directors of Compulsorily Delisted Companies Pending Fulfillment of Exit Offers to the Shareholders". Vide this Circular, SEBI has imposed certain restrictions (such as freeze on transfer, by way of sale, pledge, etc. and corporate benefits, for all equity shares[34] held by promoters; and restriction on promoters and wholetime Directors in becoming Director of any listed company) on the promoters and wholetime

24 Companies Act, 2013, S. 35.
25 Companies Act, 2013, S. 26.
26 SEBI (Issue of Capital and Disclosure Requirements) Regulations, Regn. 4.
27 SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, Regn. 7.
28 SEBI (Issue of Capital and Disclosure Requirements) Regulations, Regn. 14.
29 SEBI (Listing Obligations and Disclosure Requirements) Regulations, Regn. 5.
30 SEBI (Listing Obligations and Disclosure Requirements) Regulations, Regn. 98.
31 SEBI (Delisting of Equity Shares) Regulations, 2021, Regn. 32.
32 SEBI (Delisting of Equity Shares) Regulations, 2021, Regn. 33.
33 SEBI (Delisting of Equity Shares) Regulations, 2021, Regn. 34.
34 SEBI Circular, Restrictions on Promoters and Whole-Time Directors of Compulsorily Delisted Companies Pending Fulfillment of Exit Offers to the Shareholders, SEBI/HO/CFD/DCR/CIR/P/2016/81, (issued on 7-9-2016), Para 4(*a*).

Directors of compulsorily delisted companies, pending fulfillment of exit offers to the shareholders.[35]

However, over the years, the corporate structure in India has undergone a radical shift from promoter-oriented to investor-centric and to being professionally managed without any identifiable promoters. Moreover, due to the changing nature of ownership of listed entities, there is need to revisit the concept of promoter and promoter liabilities and shift the liabilities to person in control. This sentiment has been echoed by SEBI in its Consultation Paper on "Review of the regulatory framework of promoter, promoter group and group companies as per the ICDR Regulations" dated 11-5-2021.[36]

Such named promoters/promoter group with no involvement in affairs of the company, who lack significant managerial influence or decision-making authority within the company continue to be held accountable for regulatory violations under the existing legal framework. Such passive promoters continue to be caught in the crossfire of regulatory actions.

CONSTITUTIONALITY OF FREEZING OF PROMOTER/PROMOTER GROUP DEMAT ACCOUNTS

Several cases have emerged, where passive promoters have faced penalties due to their purported association with a company in the capacity as a promoter. These penalties often include freezing of assets, restrictions on trading, or imposition of fines even though the passive promoter may have had no control over the company's failure to meet its regulatory obligations.

There are a spate of cases, where the Securities Appellate Tribunal ("SAT") and High Courts have reprimanded the regulator and bourses for regulatory callousness and also imposed costs for illegal freezing of demat accounts of passive promoters of defaulting entities.

In *Kashyap K. Mehta* v. *BSE Ltd.*[37], a non-controlling named promoter and his wife Rupal K. Mehta, being aggrieved by freezing of their demat accounts, preferred an appeal before SAT. It was contended that named promoter, who had resigned from the post of Additional Director in August 2007 was neither in control nor had anything to do with the affairs and management of the defaulting entity Matra Realty Ltd. Despite being categorised as public shareholder, his name was erroneously shown as a promoter in the shareholding pattern of the promoter and promoter group for various quarters ending up to December 2018 and owing to regulatory non-compliance by the defaulting entity, his demat account along with his wife's demat account was frozen in

35 SEBI Circular, Restrictions on Promoters and Whole-Time Directors of Compulsorily Delisted Companies Pending Fulfillment of Exit Offers to the Shareholders, SEBI/HO/CFD/DCR/CIR/P/2016/81, (issued on 7-9-2016), Para 4(*b*).

36 Consultation Paper on streamlining disclosures by listed entities and strengthening compliance with SEBI (Listing Obligations and Disclosure Requirements) Regulations.

37 2023 SCC OnLine SAT 721.

2021 (i.e. 10 years post his resignation). Pertinently, his wife was not even a promoter in the defaulting entity and her demat account came to frozen as it was in the joint name with her husband. SAT while allowing the appeal held that the freezing of promoter's demat accounts was wholly unwarranted and directed Bombay Stock Exchange ("BSE") and National Securities Depository Ltd. ("NSDL") to defreeze the same and also rectify the shareholding pattern, reclassify Kashyap as a public shareholder.

In *Manisha B. Kadhi* v. *SEBI*[38], the demat accounts of the named promoters (i.e. Bhupendra Kadhi and his wife Mrs Manisha B. Kadhi), were frozen due to regulatory non-compliances by the company Subway Finance and Investment. Despite the Company having rectified the non-compliances, the freezing of the promoter's demat accounts was continued by BSE, owing to subsequent violations of the LODR Regulations by the Company. In this case, the appellant promoters alleged that (*i*) they are only promoters to the extent of 2% each and are not involved in the day-to-day functioning of the Company nor are they involved in the decision-making process and (*ii*) the non-compliances were subsequently rectified by the Company, accordingly, the action of the BSE in not defreezing the demat accounts was wholly arbitrary and illegal. Additionally, the appellants also challenged the legality and the validity of SEBI's Circular dated 3-5-2018 (permitting freezing of demat accounts by a recognised stock exchange) on the basis that such measure was disproportionate given the appellants' minimal stakes and lack of control over the Company. SAT while allowing the appeals, held that (*i*) freezing of the demat accounts should have been lifted once the initial violation was rectified by the Company and (*ii*) for subsequent violation of the LODR Regulations by the Company, it was open for BSE to issue fresh notice to the Company demanding compliance, failing which, BSE could proceed against the Company, Directors, promoters in accordance with law. SAT further held that the validity and legality of the SEBI circulars could only be challenged by a party in a writ jurisdiction under Article 226 of the Constitution of India and not by way of an appeal before SAT.

In *Mihir Mohan Pyne* v. *Calcutta Stock Exchange Ltd.*[39] the promoters of the defaulting entity — Camperdown Pressing Co. Ltd., being aggrieved by freezing of their demat accounts by the Calcutta Stock Exchange ("CSE"), filed a writ petition before the Calcutta High Court challenging the action of freezing of their demat accounts. The petitioners contended that CSE had not followed the mandatory steps outlined in the circular prior to freezing their accounts, such as issuing notice and allowing them an opportunity to ensure that the defaulting entity rectifies the non-compliances. The Calcutta High Court found that CSE's action of freezing the petitioner promoters' demat accounts,

38 2020 SCC OnLine SAT 237.
39 2024 SCC OnLine Cal 5123.

without prior notice, was illegal and proceeded to quash the freezing action qua the petitioner promoters as well as other promoters, with a further direction to CSE, that nothing precludes the latter from issuing a fresh notice to the petitioners to ensure that the company complies with the requirements of the LODR Regulations.

Recently, in *Pradeep Mehta case*[18], the Bombay High Court deprecated SEBI and the bourses for regulatory callousness. The Court vide its judgment and order dated 26-8-2024 set aside freezing orders in respect of demat accounts of the promoter petitioners of Shrenuj & Company Ltd./delisted entity, declaring it to be illegal and void ("the BHC order"). The Court further imposed costs of INR 80 lakhs to be jointly paid by SEBI, National Stock Exchange ("NSE") and BSE to the petitioners for such illegal freezing. However, in appeal, the Supreme Court, set aside[40] the BHC order[18] and restored the writ petition for fresh disposal before the Bombay High Court. The Apex Court noted that the High Court had erred in disposing of the writ petitions finally, when admittedly, the matter was reserved only for prayers for interim relief.

Sometime in March 2017, Dr Pradeep Mehta (named non-controlling promoter of Shrenuji) and his son Neil Mehta realised that their demat accounts were frozen due to several non-compliances by Shrenuji under the LODR Regulations. In fact, Neil Mehta was neither a Director nor promoter of Shrenuji and was merely holding a demat account in the joint name with his father, who was categorised as promoter in the Company's annual report for Financial Year 2014-2015. Upon further enquiries with their depository participant, the petitioners learnt that NSDL had issued letters dated 23-3-2017 and 13-4-2017 to their depository participant, freezing their demat accounts. The petitioners claimed that they never received the aforesaid letters issued by NSDL. Aggrieved by this action, the petitioners filed representations with SEBI, BSE and NSE, requesting the regulator and bourses to unfreeze the securities held in their demat accounts. They submitted that they (*i*) have no control whatsoever over the management and the day-to-day operations of the defaulting entity; and (*ii*) do not hold any managerial position in defaulting entity; (*iii*) the regulatory freeze was without prior notice.

The petitioner also filed appeals before SAT, which was disposed of vide order dated 18-3-2018[41], with a direction to BSE and NSE to dispose of the petitioners' representation in a time-bound manner. Pursuant to SAT's order, BSE disposed of the representations justifying the freezing action on the basis that the same was in accordance with the SEBI Circulars dated 26-10-2016 and 7-9-2016 as petitioners were named promoter.

18 "Beyond governance why promoter-led businesses need to address fraud, misconduct, and non-compliance" (deloitte.com).

40 *BSE Ltd.* v. *Pradeep Mehta*, 2024 SCC OnLine SC 3467.

41 *Pradeep Mehta* v. *National Securities Depositories Ltd.*, 2018 SCC OnLine SAT 30.

Subsequent thereto, the petitioners filed a writ petition, alleging that (*i*) Regulations 97, 98 and 99 of the LODR Regulations read with the said SEBI circulars, which empowers SEBI to delegate its powers to stock exchanges to freeze promoter demat accounts is violative of Articles 14, 21 and read with Article 300-A of the Constitution of India; (*ii*) no notices were issued to them by NSDL for freezing of their demat accounts; and (*iii*) Pradeep Mehta (named non-controlling promoter) cannot be classified as a promoter as he had no control in the Company. By way of the writ petition, the petitioners, inter alia, have prayed for (*i*) defreezing of their demat accounts and for compensation for reputational damages and financial losses; (*ii*) a direction in the nature of a mandamus to quash specific regulations (97, 98 and 99) of the LODR Regulations, as being ultra vires the SEBI Act; (*iii*) direction in the nature of a mandamus to quash circulars issued under Regulation 98 of the LODR Regulations, and a declaration that SEBI has no power to issue a circular that empowers it to delegate the power to regulate, adjudicate, penalise or freeze accounts; and (*iv*) declaration that BSE, NSE, Central Depository Services (India) Ltd. and NSDL lack the power to impose penalties or freeze accounts.

While the case is pending a fresh hearing, it raises some relevant questions on the constitutional validity of freezing of demat accounts of the promoters which are discussed hereunder.

Towards effective enforcement of the LODR Regulations, the 2020 Circular provides for freezing of "entire shareholding of the promoter(s) and the promoter group in the non-compliant entity as well as other securities held in the demat account of the promoter(s)". The existing framework casts a blanket liability on promoters for non-compliances of the defaulting entity, without specifically analysing the role/control exercised of such promoters over the defaulting entity.

If the classification is reasonable and is founded on intelligible differentia and the said differentia has a rational relation to the object sought to be achieved by the statute, then the validity of such statute cannot be successfully challenged under Article 14 of the Constitution of India. In order, however, to pass the test of permissible classification two conditions must be fulfilled, namely:

> (*i*) that the classification must be founded on an intelligible differentia which distinguishes persons or things that are grouped together from others left out of the group, and
>
> (*ii*) that that differentia must have a rational relation to the object sought to be achieved by the statute in question.[42]

It is arguable that Regulation 98(1)(*c*) of the LODR Regulations read with Para 1 of the 2020 Circular, does not pass the twin tests of a reasonable classification under Article 14. Article 14 guarantees the fundamental right to

42 *Budhan Choudhry* v. *State of Bihar*, (1954) 2 SCC 791.

equality and equality before law. The said provisions single out the Promoters of a company (whether passive promoters or those playing an active role in the company) and casts an obligation only on them to ensure rectification of non-compliances, leaving out other persons in effective control of the company (such as Wholetime Directors, Managing Directors, CEOs) who can ensure rectification of non-compliance by the company. The current framework fails to cast such liability on similarly placed persons who are in effective control of the defaulting entity. Hence, it is arguable that the said provisions offend Article 14 as the classification does not have a rational nexus with the object sought to be achieved, which is to ensure rectification of non-compliance by the defaulting entity.

Recently, SEBI has in its Consultation Paper "Streamlining Disclosures by Listed Entities and Strengthening Compliance with LODR Regulations" dated 20-2-2023[43], noted that there is need to review the aspect of freezing of promoter demat accounts as specified in the 2020 Circular. In terms of the said Consultation Paper, SEBI has mooted the idea that the demat account of the WTDs, including the MD, and CEO(s) may be frozen, in addition to the demat account(s) of the promoters, for continuing non-compliance and/or non-payment of fines by a listed entity. SEBI's recommendation is based on the understanding that "the day-to-day affairs of the company are run by the Managing Director(s), Executive Directors of the company and therefore they should be held accountable for a listed entity's continuing non-compliance with the LODR Regulations.

It is arguable that this blanket liability on promoters, fails the test of proportionality as the 2020 Circular, unlike the 2016 Circular[44], does not provide for any procedural safeguards. The 2016 Circular provided that freezing action shall be "to the extent of liability which shall be calculated on a quarterly basis". This procedural safeguard only held promoters liable to the extent of the liability of the defaulting entity and did not deprive promoters unreasonably from their property by freezing the entirety of shareholding in their demat accounts. The 2016 Circular has now been superseded by the 2020 Circular. Sans such procedural safeguard, it is arguable that the 2020 Circular fails to meet the proportionality test and is hit by the vice of Article 14. The scope of principle of proportionality was set forth in *K.S. Puttaswamy*[45], wherein the Court held that:

43 Consultation Paper on review of the regulatory framework of promoter, promoter group and group companies as per SEBI (Issue of Capital and Disclosure Requirements) Regulations.

44 SEBI, Circular, *Non-compliance with certain provisions of Listing Regulations and Standard Operating Procedure for suspension and revocation of trading of specified securities*, CIR/CFD/CMD/12/2015, (issued on 30-11-2015), Para 3.

45 *K.S. Puttaswamy (Aadhaar-5J.)* v. *Union of India*, (2019) 1 SCC 1.

(*i*) Measures that interfere with or limit the exercise of fundamental rights are justified if there exists a rational connection between those measures, the situation in fact and the object sought to be achieved; and

(*ii*) Additionally, the right-infringing measure must be necessary to achieve the objective of the Act and should not interfere or infringe the fundamental right to a greater extent than necessary.

Therefore, considering the strict thresholds set by the doctrine of proportionality, it is arguable that the 2020 Circular read with Regulation 98(1)(*c*) of the LODR Regulations is violative of Article 14.[46] It is further arguable that such disproportionate freezing of the demat accounts of the promoters is also violative of Article 300-A[47] which states that no person shall be deprived of his property save by authority of law. The Apex Court has held that a legislation providing for deprivation of property under Article 300-A must be "just, fair and reasonable" as understood in terms of Articles 14, 19(1)(*g*), 26(*b*), 301, etc.[48] Indiscriminate freezing of promoter demat accounts without specifically analysing their role/control over the defaulting entity may not be just, fair and reasonable.

Lastly, the 2020 Circular provides for freezing the demat account of the promoter in entirety. Such freezing action even extends to securities of private companies held in promoter demat accounts, which is arguably beyond the scope of SEBI's jurisdiction which only extends to listed and unlisted public companies. Accordingly, freezing the demat accounts of a promoter in entirety of a delisted entity, not only affects the promoter but also such unlisted companies, who are not eligible to make a public offer, owing to their association with such promoters.

CONCLUSION AND RECOMMENDATIONS

The current regulatory framework treats all promoters equally accountable, it fails to recognise the significant differences between persons in control and passive promoters, who do not exercise any real control/influence over the management of the company. Freezing of such passive promoters demat accounts is wholly arbitrary and distinctly disproportionate. Though SEBI's regulatory framework has played a pivotal role in strengthening India's securities market, it must evolve to reflect the changing nature of corporate governance.

Hence, keeping this shift in mind, it is suggested that the current framework should be revisited and should be made applicable only to person(s) in control who are involved in the decision-making and management of the company and who remain primarily accountable for regulatory compliances.

46 Constitution of India, Art. 14.
47 Constitution of India, Art. 300-A.
48 *K.T. Plantation (P) Ltd.* v. *State of Karnataka*, (2011) 9 SCC 1.

Therefore, SEBI also in its Consultation Paper has taken note that not only promoters but only such person(s) in control, exercise control/influence over the decision-making and/or management of the company and can therefore ensure compliance by the company.

By adopting a proportional enforcement system, and safeguarding the financial interests of passive promoters, SEBI can create a more equitable regulatory landscape. Such reforms would strike the right balance between protecting investor interests and ensuring fairness in holding individuals accountable for regulatory non-compliance, ultimately fostering a healthier and more just corporate governance system.

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