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Civil Misc. Writ Petition No. 45893 of 2012

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U.P. Stock Exchange Brokers' Association & Ors.
Vs.
Security and Exchange Board of India & Anr.

Appearance:

For the Petitioners: Mr. Ravi Kant, Senior Advocate
Mr. Saurabh Srivastava, Advocate

For the Respondents: Mr. Gaurav Banerjee, Senior Advocate
Mr. Sanjai Goswami, Advocate

Hon'ble Dr. Dhananjaya Yeshwant Chandrachud, C.J.
Hon'ble Dilip Gupta, J.

(Per Hon'ble Dr. D.Y. Chandrachud, C.J.)

The petitioners have challenged the constitutional validity of the Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012[1]. These regulations have been framed by the Securities and Exchange Board of India[2] in exercise of statutory powers conferred by two legislative enactments: the Securities Contracts (Regulation) Act, 1956[3] and the Securities and Exchange Board of India Act, 1992[4].

The first petitioner before the Court is a society registered under the Societies Registration Act, 1860 and is an association representing the interests of stock exchange brokers whose members are stated to have been engaged in trading shares and securities on the Regional Stock Exchange at

1 Referred to in the judgment as the SECC Regulations
2 "SEBI"
3 "SCRA"
4 "SEBI Act"

Kanpur. The second petitioner is its President, while the third petitioner is a trading Member and Director of the governing body of the Uttar Pradesh Stock Exchange Limited, a body corporate, which is impleaded as the second respondent to these proceedings.

The challenge has been confined at the hearing to the validity of Regulations 6, 7, 14, 16, 17, 19, 20, 21(1)(b), 23, 24 and 25. The validity of the regulations has been challenged on four grounds:

(i) the regulations "completely muzzle" the fundamental right guaranteed by Article 19 (1) (c) of the Constitution, on a citizen to form an association by choosing its members and directors;

(ii) the regulations "totally supplant" the provisions of Section 4(b), 5, 7A, 11 and 31 of the SCRA and Rules 4, 5 & 6 (read with Form A) of the Securities Contracts Rules[5];

(iii) the regulations "sail far beyond the bounds set down by the SCRA and the rules and since they constitute sub delegated legislation, must yield to the statute[6]; and

(iv) the regulations amount to a prohibition on the fundamental right to carry on business and trade under Article 19 (1) (g) of the Constitution and make a deep inroad into the rights of the petitioners to carry on their trade and business.

The provisions under challenge

The SECC Regulations are referable to the provisions of Sections 4, 8A and 31 of the SCRA and Sections 11 and 31 of the SEBI Act.

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5 "the Rules"

6 Propositions (ii) and (iii) are essentially interrelated and can conveniently be dealt with together.

Recognition

Regulation 3 provides that no person shall conduct, organize or assist in organizing any stock exchange or clearing corporation unless he has obtained recognition from SEBI in accordance with the SCRA, rules and regulations. A stock exchange, which was recognized under the SCRA, at the commencement of the regulations is deemed to have been recognized under the regulations. An existing clearing house of a recognized stock exchange was allowed to continue for a period of three months from the commencement of the regulations or, if an application was made under Regulation 4 for recognition, till the disposal of the application.

Regulation 4 provides for an application for recognition as a stock exchange. Regulation 6(1) stipulates that an application for recognition has to be accompanied by copies of the memorandum of association, articles of association, bye laws and other documents provided in Sections 3 and 4 of the SCRA, Rule 5 of the Rules and the Regulations. The application is also to be accompanied by agreements entered into by the applicant with recognized stock exchanges and depositories. Clauses (1) and (2) of Regulation 7 govern, inter alia, applications seeking recognition as a stock exchange or clearing corporation. Clauses (1), (2) and (3) of Regulation 7 provides as follows:

> "**7.** (1) The application under regulation 4 shall be governed by the provisions of the Act, rules and these regulations.
>
> (2) An applicant seeking recognition as a stock exchange or clearing corporation shall comply with the following conditions, namely:—

(a) the applicant is a company limited by shares;

(b) the applicant is demutualised;

(c) the applicant, its directors and its shareholders who hold or intend to hold shares, are fit and proper persons as described in regulation 20;

(d) the applicant satisfies requirements relating to ownership and governance structure specified in these regulations;

(e) the applicant satisfies net worth requirements specified in these regulations;

(f) the applicant satisfies requisite capability including its financial capacity, functional expertise and infrastructure.

Explanation.—For the purposes of this sub-regulation, the term "demutualised" means that the ownership and management of the applicant is segregated from the trading rights or clearing rights, as the case may be, in terms of these regulations.

(3) An applicant seeking recognition as a stock exchange shall, in addition to conditions as specified in sub-regulations (1) and (2), comply with the following conditions, namely:—

(a) the applicant has the necessary infrastructure for orderly execution of trades;

(b) the applicant has an online screen-based trading system;

(c) the applicant has an online surveillance capability which monitors positions, prices and volumes in real time so as to ensure market integrity;

(d) the applicant has adequate infrastructure to list securities for trading on its platform, wherever applicable;

(e) the applicant has necessary capability to have a nationwide network of trading members and has adequate facility to admit and regulate its members;

(f) the applicant has made necessary arrangements to establish connectivity with its trading members and clearing corporation;

(g) the applicant has adequate Investor Protection Fund and Investor Services Fund;

(h) the applicant has adequate investor grievances redressal mechanism and arbitration mechanism to resolve disputes arising out of trades and its settlement;

(i) the applicant has the facility to disseminate information about trades, quantities and quotes in real time to at least two information vending networks which are accessible to investors in the country;

(j) the applicant has adequate systems' capacity supported by a business continuity plan including a disaster recovery site;

(k) the applicant has in its employment, sufficient number of persons having adequate professional and other relevant experience;

(l) the business feasibility plan has been appraised by a reputed agency having expertise in securities market; and

(m) any other conditions as may be specified by the Board."

Under Regulation 9, SEBI, after considering the application and on being satisfied that the applicant has complied with the conditions laid down in Regulation 7 and is eligible to act as a recognized stock exchange, is

empowered to grant recognition under Section 4 of the SCRA in the interest of the securities market.

New worth

Chapter III of the SECC Regulations deals with the net worth of stock exchanges and clearing corporations. Regulation 14(1) contains a stipulation to the following effect:

> **"14.** (1) Every recognised stock exchange shall have a minimum net worth of one hundred crore rupees at all times:
>
> Provided that a recognised stock exchange having a lesser net worth as on the date of commencement of these regulations shall achieve a minimum net worth of one hundred crore rupees within a period of three years from the date of commencement of these regulations."

A similar requirement is imposed in respect of the recognition of a clearing corporation by clause (2). Under clause (4), a recognized stock exchange is not allowed to distribute profits in any manner to its shareholders, unless the net worth requirement is achieved. Explanation I defines the expression "net worth of a stock exchange" as follows:

> *"Explanation I.*—For the purposes of this regulation, 'net worth of a stock exchange' means the aggregate value of paid up equity share capital plus free reserves (excluding statutory funds, benefit funds and reserves created out of revaluation) reduced by the investments in businesses, whether related or unrelated, aggregate value of accumulated losses and deferred expenditure not written off, including miscellaneous expenses not written off."

Ownership

Chapter IV of the SECC Regulations prescribes requirements in regard to the ownership of stock exchanges and clearing corporations. Regulation 16 (1) contains a stipulation that the shareholding or voting rights of any person in a recognized stock exchange or a recognized clearing corporation shall not exceed the limits specified in the Chapter at any point of time. Under clause (2), the shareholding is to include any instrument owned or controlled, directly or indirectly which provides for entitlement to equity or rights over equity at any future date. Regulation 17 is to the following effect:

> "**17.** (1) At least fifty one per cent of the paid up equity share capital of a recognised stock exchange shall be held by public.
>
> (2) No person resident in India shall at any time, directly or indirectly, either individually or together with persons acting in concert, acquire or hold more than five per cent of the paid up equity share capital in a recognised stock exchange:
>
> Provided that,—
>
> (i) a stock exchange;
>
> (ii) a depository;
>
> (iii) a banking company;
>
> (iv) an insurance company; and
>
> (v) a public financial institution,
>
> may acquire or hold, either directly or indirectly, either individually or together with persons acting in concert, up to fifteen per cent of the paid up equity share capital of a recognized stock exchange.
>
> (3) No person resident outside India, directly or indirectly, either individually or together with persons

acting in concert, shall acquire or hold more than five per cent of the paid up equity share capital in a recognized stock exchange.

(4) The combined holding of all persons resident outside India in the paid up equity share capital of a recognized stock exchange shall not exceed, at any time, forty-nine per cent of its total paid up equity share capital, subject to the following:—

(a) the combined holding of such persons acquired through the foreign direct investment route shall not exceed twenty six per cent of the total paid up equity share capital, at any time;

(b) the combined holding of foreign institutional investors shall not exceed twenty three per cent of the total paid up equity share capital, at any time;

(c) no foreign institutional investor shall acquire shares of a recognised stock exchange otherwise than through secondary market.

Explanation.- For the purposes of clause (c), the acquisition of shares in a recognised stock exchange through secondary market shall be construed as follows: —

I. If the recognised stock exchange is not listed, a foreign institutional investor may acquire its shares through transactions outside of a recognised stock exchange provided it is not an initial allotment of shares;

II. If the recognised stock exchange is listed, the transactions by a foreign institutional investor shall be done through the recognised stock exchange where such shares are listed.

(5) No clearing corporation shall hold any right, stake or interest, of whatsoever nature, in any recognised stock exchange.

Hence, under Regulation 17 restrictions have been laid down under which:

(i) at least 51 percent of the paid up equity share capital of a recognized stock exchange shall be held by the public;

(ii) a person resident in India cannot hold more than 5 percent of the paid up equity share capital directly or indirectly, either individually or together with persons acting in concert;

(iii) in the case of stock exchanges, depositories, banking companies, insurance companies and public financial institutions, a cap of 15 percent is provided for holding of paid up equity share capital in a recognized stock exchange;

(iv) a person resident outside India is subject to a cap of 5 percent of the holding of equity share capital in a recognized stock exchange; and

(v) the combined holding of all persons resident outside India cannot exceed 49 percent of the total paid up equity share capital subject to (a) a cap of 26 percent on holding which has been acquired through the FDI route; (b) a cap of 23 percent for FIIs; (c) a prohibition on an FII acquiring shares of a recognized stock exchange through the secondary market.

Fit and Proper criterion

Regulation 19 defines the norms of eligibility for the acquisition or holding of shares. Under clause (1) of Regulation 19, there is a prohibition

on a person acquiring or holding equity shares of a recognized stock exchange or recognized clearing corporation directly or indirectly, unless "he is a fit and proper person". Under clause (2), a person who acquires equity shares so that his holding exceeds two percent of the paid up equity capital share has to seek approval of SEBI within 15 days of the acquisition, failing which the excess shareholding has to be divested. Finally, under clause (6) of Regulation 19, a person who holds more than two percent of the paid up equity share capital has to file a declaration within fifteen days at the end of every financial year, that he complies with the 'fit and proper' criteria.

Regulation 20 elucidates "fit and proper criteria" in the following terms:

> "**Fit and proper criteria.**
>
> **20**. (1) For the purposes of these regulations, a person shall be deemed to be a fit and proper person if—
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> (a) such person has a general reputation and record of fairness and integrity, including but not limited to—
>
> (i) financial integrity;
>
> (ii) good reputation and character; and
>
> (iii) honesty;
>
> (b) such person has not incurred any of the following disqualifications—
>
> (i) the person, or any of its whole time directors or managing partners, has been convicted by a court for any offence involving moral turpitude or any economic offence or any offence against the securities laws;
>
> (ii) an order for winding up has been passed against the person;

(iii) the person, or any of its whole time directors or managing partners, has been declared insolvent and has not been discharged;

(iv) an order, restraining, prohibiting or debarring the person, or any of its whole time directors or managing partners, from dealing in securities or from accessing the securities market, has been passed by the Board or any other regulatory authority, and a period of three years from the date of the expiry of the period specified in the order has not elapsed;

(v) any other order against the person, or any of its whole time directors or managing partners, which has a bearing on the securities market, has been passed by the Board or any other regulatory authority, and a period of three years from the date of the order has not elapsed;

(vi) the person has been found to be of unsound mind by a court of competent jurisdiction and the finding is in force; and

(vii) the person is financially not sound.

(2) If any question arises as to whether a person is a fit and proper person, the Board's decision on such question shall be final."

Under Regulation 21, every recognized stock exchange has to disclose to SEBI its shareholding on a quarterly basis including the names of ten largest shareholders together with the number and percentage of shares held and the names of shareholders falling under Regulations 17 and 18, who had acquired shares in that quarter.

Governance

Chapter V of the SECC Regulations makes provisions for governance of stock exchanges and clearing corporations. Regulation 23 contains stipulations about the composition of governing board. Under clause (1), the governing board of every recognized stock exchange is to include:

(i) shareholder directors;

(ii) public interest directors; and

(iii) a managing director.

The stipulations that have been contained in Regulation 23 are:

(i) a requirement that the chairperson be elected by the governing board amongst public directors[7];

(ii) the number of public interest directors shall not be less than number of shareholder directors[8];

(iii) the number of public interest directors of a recognized clearing corporation will not be less than two-third and shareholder directors shall not exceed one-third of the strength of the governing board[9];

(iv) the managing director is an ex officio director of the governing board and will not be included in either the category of public interest directors or shareholder directors[10];

(v) no trading member or clearing member, or his associates and agents shall be on the governing board of any recognized stock exchange[11];

7 Regulation 23 (2)
8 Regulation 23 (3)
9 Regulation 23 (4)
10 Regulation 23 (5)
11 Regulation 23 (7)

(vi) in order to constitute a quorum, at least one public interest director must be present at the meeting of the governing board[12]; and

(vii) an FII will not be represented on the governing board[13].

Regulation 24 of SECC Regulations lays down conditions for the appointment of directors. These conditions are:

(i) appointment and reappointment of all shareholder directors on the governing board shall be with the prior approval of the SEBI[14];

(ii) public interest directors in the governing board shall be nominated by SEBI[15] and for a fixed term of three years or an extended period as approved by the SEBI[16];

(iii) the decision of SEBI would be final as to whether an assignment or position of a public interest director involves a conflict with his role[17];

(iv) a public interest director may be renominated after a cooling-off period of one year or such period as SEBI may deem fit in the interest of securities market[18]; and

(v) public interest directors are to be paid only sitting fees as specified in the Companies Act[19].

The appointment of a managing director is under Regulation 25 (1) subject to approval of SEBI. Renewals and terminations similarly require SEBI's approval. Under clause (2), the stock exchange is empowered to determine the qualifications, manner of appointment, terms and conditions of appointment and other procedural formalities for the selection and

12 Regulation 23 (8)
13 Regulation 23 (9)
14 Regulation 24 (1)
15 Regulation 24 (2)
16 Regulation 24 (3)
17 Regulation 24 (4)
18 Regulation 24 (5)
19 Regulation 24 (6)

appointment of a managing director, subject to guidelines issued by SEBI. The tenure of a managing director is not to exceed five years and is to be not less than three years. Clause (4) of Regulation 25, inter alia, contains the prohibitions on a managing director being a shareholder, trading member or holding a position concurrently in a subsidiary of or an associated entity of a recognized stock exchange:

> "(4) The managing director of a recognised stock exchange or a recognised clearing corporation shall not—
>
> (a) be a shareholder or an associate of a shareholder of a recognised stock exchange or recognised clearing corporation or shareholder of an associate of a recognised stock exchange or recognised clearing corporation, as the case may be;
>
> (b) be a trading member or a clearing member, or his associate and agent, or
>
> shareholder of a trading member or clearing member or shareholder of an associate and agent of a trading member or a clearing member; or
>
> (c) hold any position concurrently in the subsidiary of a recognised stock exchange or a recognised clearing corporation, or in any other entity associated with a recognized stock exchange or a recognised clearing corporation:"

SEBI, under clause (6) of Regulation 25 is empowered suo motu to remove or terminate the appointment of a managing director after a reasonable opportunity of being heard, if it so deems fit in the interest of securities market.

We now proceed to deal with the constitutional challenges.

SCRA

The post World War – II boom in stock exchanges between 1945 and 1946 brought home the need and urgency for a reform of stock exchanges across the country. The Bill was introduced following the recommendations of the Gorwala Committee. The scheme of regulation contemplated in the Bill basically provided for (i) prior recognition of stock exchanges, subject to the fulfillment by them of conditions relating to membership, rules and bye-laws; (ii) a general control over trading methods and practices which was to be exercised through the powers conferred on the Central Government to approve of the rules, regulations and byelaws of stock exchanges and to make or amend them. The Central Government was empowered to regulate stock exchanges by calling for information in respect of the affairs of stock exchanges and to direct investigations, if they were considered necessary in the interest of trading or in public interest. Restrictions were imposed on certain transactions in securities carried on in and outside recognized stock exchanges and a prohibition was imposed on dealing with options in securities.

Section 4 of the SCRA provided for recognition of stock exchanges by the Central Government. Sub-sections (1) and (2) of Section 4 provide as follows:

> "**4. Grant of recognition to stock exchanges. –** (1) If the Central Government is satisfied, after making such inquiry as may be necessary in this behalf and after obtaining such further information, if any, as it may require,—
>
> (*a*) that the rules and bye-laws of a stock exchange applying for registration are in conformity with such

conditions as may be prescribed with a view to ensure fair dealing and to protect investors;

(*b*) that the stock exchange is willing to comply with any other conditions (including conditions as to the number of members) which the Central Government, after consultation with the governing body of the stock exchange and having regard to the area served by the stock exchange and its standing and the nature of the securities dealt with by it, may impose for the purpose of carrying out the objects of this Act; and

(*c*) that it would be in the interest of the trade and also in the public interest to grant recognition to the stock exchange; it may grant recognition to the stock exchange subject to the conditions imposed upon it as aforesaid and in such form as may be prescribed.

(2) The conditions which the Central Government may prescribe under clause (*a*) of sub section (1) for the grant of recognition to the stock exchanges may include, among other matters, conditions relating to,—

(*i*) the qualifications for membership of stock exchanges;

(*ii*) the manner in which contracts shall be entered into and enforced as between members;

(*iii*) the representation of the Central Government on each of the stock exchanges by such number of persons not exceeding three as the Central Government may nominate in this behalf; and

(*iv*) the maintenance of accounts of members and their audit by chartered accountants whenever such audit is required by the Central Government."

Section 5 provides for withdrawal of recognition by the Central Government in the interest of the trade or in public interest. Section 7A empowers recognized stock exchanges, inter alia, to make rules restricting voting rights. Sub-section (1) of Section 7A is as follows:

> **"7A.** (1) A recognised stock exchange may make rules or amend any rules made by it to provide for all or any of the following matters, namely:—
>
> (*a*) the restriction of voting rights to members only in respect of any matter placed before the stock exchange at any meeting;
>
> (*b*) the regulation of voting rights in respect of any matter placed before the stock exchange at any meeting so that each member may be entitled to have one vote only, irrespective of his share of the paid-up equity capital of the stock exchange;
>
> (*c*) the restriction on the right of a member to appoint another person as his proxy to attend and vote at a meeting of the stock exchange;
>
> (*d*) such incidental, consequential and supplementary matters as may be necessary to give effect to any of the matters specified in clauses (*a*), (*b*) and (*c*)."

Under Section 8, the Central Government is empowered, where it is of opinion that it is necessary or expedient so to do, to issue an order, accompanied by reasons, directing recognized stock exchanges generally or a particular exchange, to make any rules or to amend the rules already made in respect of matters specified in sub-section (2) of Section 3 pertaining to the application for recognition. Section 9 empowers recognized stock exchanges to make bye-laws with the previous approval of SEBI for the regulation and control of contracts. (The reference to SEBI, as we shall

examine is a subsequent legislative amendment). Section 10 empowers SEBI to make bye-laws or to amend the bye-laws made by a recognized stock exchange after consulting the governing body of the stock exchange where it is necessary or expedient to do so. Section 11 empowers the Central Government to supersede the governing body of a stock exchange after furnishing an opportunity of being heard.

The SCRA was subjected to legislative amendment at various stages particularly so as to comprehend the regulatory powers which were imposed upon SEBI upon the enactment of the SEBI Act in 1992. SEBI was constituted as an expert authority and is vested with statutory functions and duties in relation to the securities market. Section 12A was introduced into the SCRA so as to empower SEBI to issue directions to stock exchanges as well as to companies whose securities are listed or proposed to be listed in a recognized stock exchange, in the interest of investors and of the securities market, if SEBI is satisfied that it is necessary (a) in the interest of investors or orderly development of the securities market; (b) to prevent the affairs of a recognized stock exchange being conducted in a manner detrimental to the interests of investors or the securities market; or (c) to secure the proper management of a stock exchange. Section 29A[20] was introduced by a Parliamentary amendment to enable the Central Government to delegate its powers under the Act (except for the rule making power) to SEBI or to the Reserve Bank of India. Section 29A provides as follows:

> **"29A. Powers to delegate.-** The Central Government may, by order published in the Official Gazette, direct that the powers (except the power under

20 Act 15 of 1992 as substituted by Act 31 of 1999 w.e.f. 22 February 2000

> section 30) exercisable by it under any provision of this Act shall, in relation to such matters and subject to such conditions, if any, as may be specified in the order, be exercisable also by the Securities and Exchange Board of India or the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934 (2 of 1934)."

Section 31 has been amended and, in its present form, empowers SEBI to make regulations consistent with the provisions of the SCRA and the rules to carry out the purposes of the Act. This is to be without prejudice to the provisions contained in Section 30 of the SEBI Act. The regulations, amongst other things, may provide for the manner in which at least 51percent of the equity share capital of a recognized stock exchange is to be held by the public other than the shareholders having trading rights.

The SCRA, as it was originally enacted, conferred over-arching regulatory powers upon the Central Government. With the establishment of SEBI and the enactment of the SEBI Act 1992, Parliament envisioned that SEBI would be an expert regulator for the regulation of the market in securities and for defining and regulating the activities of stakeholders who had a vital bearing on the transparent and accountable functioning of the securities' market. The amendments to the SCRA have hence been dovetailed with the statutory provisions under the SEBI Act empowering SEBI to regulate the securities market. In 2005, the principle of corporatization and demutualization of stock exchanges received statutory recognition. Hence, in Section 4A of the SCRA, the legislative amendment conferred significant powers upon SEBI to oversee the achievement of this

process. As regards corporatization, a legal succession was provided for recognized stock exchanges into companies incorporated for the purpose of regulating or controlling the business of dealing in securities. As a result of the process of demutualization a segregation was brought about by Parliament between ownership and management on the one hand and the trading rights of members on the other hand, of a recognized stock exchange in accordance with the scheme to be approved by SEBI. The amendments which were made to the SCRA constituted a legislative acknowledgement that SEBI, following the enactment of the SEBI Act was the expert which was being vested with the duty to protect the interests of investors in securities and to promote the development of, and to regulate the securities market.

Section 11 of SEBI Act

Section 11 (1) of the SEBI Act provides that it shall be the duty of SEBI to protect the interests of investors in securities and to promote the development of, and to regulate the securities market by such measures as it deems fit. Sub-section (2) which provides illustrations of measures which SEBI may adopt, includes in clause (j):

> "(j) Performing such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act, 1956 (42 of 1956), as may be delegated to it by the Central Government;"

Consequently, the delegation of powers of the Central Government which is contemplated under Section 29A of the SCRA finds a reflection in the corresponding provisions of Section 11 (2) (j) of the SEBI Act. Under

Section 30 (1), SEBI is empowered to make regulations consistent with the provisions of the SEBI Act and the rules made thereunder, to carry out the purposes of the Act.

Delegation to SEBI of the powers of Central Government

In exercise of the powers which were conferred by Section 29A of the SCRA, the Central Government issued a notification on 30 July 1992 directing that the powers exercisable by it under Section 4 (5), Section 7 and Sections 8, 11, 12 and 16 were delegated concurrently to SEBI. Another notification for delegation was issued by the Union Government on 13 September 1994. The Press Note which was issued by the Union Ministry of Finance in the Department of Economic Affairs, to explain the reason for the delegation states that:

> "4. With the delegation of these additional powers, it is envisaged that SEBI will exercise most of the powers under the Act. The delegation of these additional powers to SEBI is intended to ensure a more effective protection of the interests of investors and to create an efficient and well-regulated stock market." (emphasis supplied).

Consequently, the regulatory regime as it is conceived under the two legislative enactments, is that upon the delegation of powers to SEBI by the Central Government, it was SEBI which would exercise most of the powers under the SCRA. Significantly, this delegation was intended to ensure a more effective protection of the interest of investors and to create an efficient and well regulated stock market.

The reason for this shift in focus was noted in the judgment of the Supreme Court in **Swedish Match AB & Anr. Vs. Securities & Exchange Board of India & Anr.**[21]:

> "Establishment of independent regulatory agencies and need for expert regulations were long felt primarily as a response to the growing complexity in human affairs and trade and business in particular. It was felt that a regulator who was aware of the realities of that field, should be ready to regulate that field. Demand for regulators who were not mere Government officials but people who are experts in the field came up. Regulations framed by an expert body like SEBI were felt to be an effective substitute for government regulation, the evolution in respect whereof can be traced back to the Great Depression of 1930s. As a part of the new deal, several expert bodies were established like the Federal Communications Commission and the Securities Exchange Commission. In the Indian context, this rationale was invoked for the establishment of an expert body to regulate the securities market after the Securities Scam in 1992."

The powers which have been conferred upon SEBI by Section 11 have been construed by the Supreme Court in the recent judgment in **Sahara India Real Estate Corporation Limited & Ors. Vs. Securities and Exchange Board of India & Anr.**[22] to be "the heart and soul" of the SEBI Act. Construing the width and amplitude of the provisions contained in Section 11 (1) of the SEBI Act, Hon'ble Mr. Justice J.S. Khehar observed as follows:

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21 (2004) 11 SCC 641
22 (2013) 1 SCC 1

> "…It is, therefore, apparent that the measures to be adopted by SEBI in carrying out its obligations are couched in open-ended terms, having no pre-arranged limits. In other words, the extent of the nature and the manner of measures which can be adopted by SEBI for giving effect to the functions assigned to SEBI, have been left to the discretion and wisdom of SEBI. It is necessary to record here, that the aforesaid power to adopt "such measures as it thinks fit" to promote investors' interest, to promote the development of the securities market and to regulate the securities market, has not been curtailed or whittled down in any manner by any other provisions under the SEBI Act, as no provision has been given overriding effect over sub-section (1) of Section 11 of the SEBI Act."

Ultra Vires challenge

Viewed in this background, it is not possible to accede to the submission that the SECC Regulations supplant or are ultra vires the SCRA or the rules which have been framed under it. Rule 3 of the Rules, in fact, contemplates that an application for recognition has to be made to SEBI and not to the Central Government. The regulations which have been framed by SEBI are in exercise of powers conferred by Sections 4, 8A and 31 of the SCRA. Section 31 of the SCRA expressly confers power upon SEBI to make regulations which are consistent with the Act and the rules, to carry out the purposes of the Act. SEBI, in framing the SECC Regulations, has acted plainly in pursuance of the statutory powers conferred upon it and has not traveled beyond the bounds of the statute. The Regulations are also referable to the provisions of Section 11 and Section 30 of the SEBI Act. SEBI, under Section 11, is entitled to regulate the securities market by such

measures as it think fit to protect the interest of investors and to promote the development of the securities market. The measures which SEBI can adopt, include the discharge of those functions and powers which have been delegated to it by the Central Government under the SCRA. In Chapter II of the Regulations, SEBI has prescribed conditions for recognition of stock exchanges. In Chapter III, SEBI has prescribed net worth requirements. In Chapter IV, SEBI has prescribed requirements in relation to ownership of stock exchanges. Chapter V stipulates norms for governance of stock exchanges. This exercise of framing regulations in pursuance of the subordinate legislative power, which is conferred upon SEBI is within the bounds of the statutute. SEBI has not acted ultra vires, either the SEBI Act or the SCRA.

We would be examining in detail the challenges to the regulations on the ground that they violate Article 19 (1) (c) and Article 19 (1) (g) of the Constitution. It is to those aspects, that we now turn.

Jalan Committee Report

Traditionally, stock markets bring together those who demand capital (corporations) and those who supply capital (investors). Stock exchanges provide liquidity for investors to invest and disinvest without significant price variability. Essentially, stock exchanges provide a facility for investors to transact on the securities market and to realise the price for securities traded on them. In this sense, stock exchanges constitute a part of the essential economic infrastructure of a modern economy. Andreas M. Fleckner, in an article published in Fordham Law Review titled 'Stock

Exchanges at the Crossroads[23] describe stock exchanges as 'market organizers'. In a significant measure, stock exchanges allocate capital. The prices of securities traded in the stock market provide a foundation for an efficient allocation of financial resources by bringing together innumerable investors who seek through their decisions to invest and disinvest, a measure of liquidity. While providing a platform to investors to transact in securities, stock exchanges in the cumulative effect of their functions allocate capital resources. A stock exchange at one level provides a transaction facility for individual investors. At a macro level, stock exchanges determine through the interplay of market forces capital allocation in the economy. Volatality in the stock market disturbs both the equilibrium and balance in the efficient allocation of resources for the economy.

Traditionally, stock exchanges provided platforms for transactions in securities on the floor of the exchange where brokers met, negotiated and agreed upon the prices for stock transfers executed for their principals. With modern technology having permeated almost every aspect of life, the trading floor of the stock exchange has become obsolescent. Stock exchanges maintain electronic systems world wide that match orders for buying and selling of shares automatically. Stock exchanges are market organisers. Apart from the function of being market organisers, stock exchanges are (i) information distributors; (ii) regulators of the market which they organise; (iii) involved in setting standards of corporate governance through their listing rules; and (iv) at an institutional level, business enterprises. In the judgment of the Bombay High Court in **MCX Stock Exchange Limited Vs.**

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23 April 2006

Securities and Exchange Board of India & Ors.[24] delivered by one of us (D.Y. Chandrachud, J), the role of exchanges as "the first layer of oversight" was noticed in the following observations:

> "51. Stock exchanges provide what is described as "the first layer of oversight". In many areas, stock exchanges are self regulators. As self regulatory organizations, stock exchanges have a front-line responsibility for regulation of their markets and for controlling compliance by members of rules to which they are subject. They ensure, in that capacity, compliance of the requirements established by the statutory regulator. Apart from the regulation of members, market surveillance carried on by stock exchanges in certain jurisdictions regulates issuers. They do so by ensuring that the stocks of issuers are reliably traded and that issuers meet standards of corporate governance. In exercising these powers, stock exchanges may face issues involving a conflict of interest. Such conflicts of interest have to be handled and addressed effectively within the regulatory framework."

The conflicts of interest, as we shall examine have been issues of serious regulatory concern and intervention.

The global financial crisis in 2008 impacted the international economic order besides manifesting itself in serious financial instability in economies across the world. India, as contemporary experience indicates, was not immune from its aftermath. A volatile securities market is a source of grave peril to investor confidence. SEBI constituted a Committee chaired by Dr. Bimal Jalan, former Governor of Reserve Bank of India, to examine issues arising from the ownership and governance of Market Infrastructure

24 (2012) 2 Comp LJ 473 (Bom)

Institutions (MIIs). The report of the Jalan Committee in 2010 adverted to the position of these institutions as constituting "the nucleus of (the) capital allocation system", indispensable for economic growth and constituting a part of the vital economic infrastructure. The Jalan Committee noted that unlike typical financial institutions, the number of stock exchanges, depositories and clearing corporations in an economy is limited due to the nature of their business. Any failure of those institutions could lead to bigger cataclysmic collapses that may result in an overall economic downfall that could potentially extend beyond the boundaries of the securities market and the country. The Jalan Committee characterized the price signals produced by stock markets as partaking of a public good. The price signals produced by these institutions was, in the view of the Committee, something which must be accessible to every one and must be governed by a transparent and efficient market economy. Unless the prices are fair, that would result in the expropriation of unjust profits by any one side to the transaction. The Jalan Committee observed that the nature of the public good that is supplied collectively by market infrastructure institutions is dependent exclusively on the quality and integrity of the process that accompanies its production. Hence, to ensure dependability of the process, some degree of regulatory powers have to reside within these institutions to varying degrees. The Jalan Committee emphasized that the position of MIIs in the country was capable of producing serious conflicts of interest which require SEBI to play an active role so as to ensure a level playing field.

The Jalan Committee, in the course of its recommendations, emphasized the need for a dispersed ownership structure that would ensure

that a single entity does not acquire a position of dominance. It was in that background that the Committee recommended the imposition of a cap on shareholding. On the composition of the Board for stock exchanges, the Jalan Committee highlighted that there were possibilities of a conflict of interest when shareholders with commercial motives acquire decision making roles in an entity which also performs regulatory functions. In that context, it observed thus:

> "Trading members on the board of a stock exchange are privy to confidential information. This therefore can give rise to conflict of interest when the entity regulated by the stock exchange is also on the board of the stock exchange. Conflict of interest also arises when shareholders with commercial motives form a majority in an entity which also has regulatory functions to perform.
>
> Moreover, in institutions which are subject to dispersed shareholding requirements or where the shareholders consist of mainly public sector financial institutions, the board may end up being a little more than a 'rubber stamp' for management's decisions."

It was in this background that the Jalan Committee opined that no trading or clearing member should be allowed on the board of any stock exchange and the number of public interest directors should be equal at least to the number of shareholder directors without trading interest. At the same time, the experience and expertise of the trading members could be utilized in the form of an Advisory Committee.

In justification of imposing net worth requirements, the Jalan Committee explained its rationale thus:

> "NET WORTH REQUIREMENT: MIIs by their very nature necessitate huge, long-term, sunk investments. Hence, net worth is one of the important eligibility criteria for setting up an MII. It is required for meeting the initial capital required towards infrastructure and ensures that only serious players enter this arena.
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> SEBI has already prescribed a net worth requirement of Rs.100 crores for depositories..."

Hence, the Committee recommended that stock exchanges must have a net worth of Rs. 100 crores at all times. The view of the Jalan Committee on net worth was that a market infrastructure institution should be a well capitalized entity, so that this net worth is available as a last resort to meet exigencies and to ensure that it is able to remain as a going concern.

The Jalan Committee was set up on 6 January 2010. The report of the Committee was submitted on 22 November 2010 after a wide ranging consultation involving all stakeholders. The report was placed on the website of SEBI on 23 November 2010. The Federation of Indian Stock Exchanges furnished its response on 25 December 2010 to SEBI. The agenda for the SEBI Board of 2 April 2012 included the comments of the Jalan Committee and the responses of various stakeholders. SEBI made its recommendations and eventually the regulations were notified with effect from 20 June 2012.

MIMPS Regulations 2006

Even before the SECC Regulations were notified in 2012, SEBI had, in the exercise of its regulatory powers, notified in 2006 the Securities Contracts (Regulation) (Manner of Increasing and Maintaining Public

Shareholding in Recognised Stock Exchanges) Regulations, 2006. These regulations, known by the acronym 'MIMPS regulations', were applicable to all recognised stock exchanges in respect of which a scheme for corporatisation or demutualisation had been approved by SEBI under Section 4 (B) of the SEBI Act. The MIMPS regulations, amongst other things, provide: (i) a requirement under Regulation 4, that a recognised stock exchange shall ensure that at least 51 percent of its equity share capital is held by the public; (ii) a requirement in Regulation 8, that no resident shall hold, directly or indirectly, either individually or together with persons acting in concert, more than five percent of the equity share capital of a recognised stock exchange with an enhanced cap of 15 percent for certain institutions such as depositories, banking companies, insurance companies and public financial institutions; (iii) a cap of 49 percent for all persons resident outside India in the equity share capital of a recognised stock exchange under Regulation 8 coupled with caps of 26 percent on holdings acquired through the foreign direct investment route; 23 percent on the holding of FIIs and 5 percent on a foreign investor; (iv) a requirement in Regulation 9 that no person shall hold more than five percent of the paid up equity capital of a recognised stock exchange, directly or indirectly, either individually or together with persons acting in concert. Regulation 11(1) (b) imposes an obligation on a recognised stock exchange to monitor and ensure that no transfer or issue of equity shares is made otherwise than in accordance with the regulations; that at least 51 percent of the equity share capital is continuously held by the public and that the restrictions contained in Regulations 8 and 9 are complied with.

Under the U.P. Demutualisation Scheme 2005, the second respondent was demutualised. In consequence, ownership and management rights were segregated from the trading rights of members. Under the Scheme and the MIMPS Regulations 2006, the second respondent agreed that at least fifty one percent of the equity shares would be held by the public with a cap of five percent for each individual shareholder. The governing board was recast to limit the number of trading members. Hence, even prior to the enforcement of SECC Regulations, the public share holding of the second respondent was 51 percent. The dilution of shareholding rights was, therefore, as urged by the learned ASG, a fait accompli and there was no challenge either to demutualisation or to the MIMPS Regulations 2006.

This analysis would indicate the reasons which led to the issuance of the SECC Regulations. SEBI, in making the regulations, was guided by the overwhelming public interest of protecting the interest of investors and in ensuring the orderly functioning of the securities market. The expert regulator was guided, at every stage, by its own administrative experience in regulating the stock market. The conflicts of interest within stock exchanges, the impact of those conflicts on the stability of the securities market and the grave potential for danger by the concentration of power were within the knowledge of SEBI. That the fears of SEBI were not unreal is a matter borne out by precedent. Only by way of an illustration, a reference may be made to the judgment of the Bombay High Court in **Anand Rathi & Ors. Vs. Securities and Exchange Board of India & Anr.**[25] where an

25 (2002) Vol 110 CC 837

investigation by SEBI revealed that the President of a stock exchange had called for sensitive price information from the surveillance department to secure private ends.

Article 19 (1) (c) of the Constitution

Article 19 (1) (c) guarantees to all citizens the right to form associations or unions. The right is subject to the qualification in clause (4) by which nothing in sub-clause shall (i) affect the operation of any existing law insofar as it imposes or prevent the State from making any law imposing, in the interest of public order or morality, reasonable restrictions on the exercise of the right conferred by the sub-clause.

As we approach the task of constitutional adjudication, it would be necessary for the Court to bear in mind certain fundamental precepts. First, there is a presumption of constitutionality and associated with it, the burden which lies on a person who assails a law to establish its invalidity. Second, where subordinate legislation is sought to be questioned, it must be shown to suffer from the vice of manifest arbitrariness. Third, in areas of economic or financial regulation, the legislature and its delegate are entitled to a greater degree of latitude. The legislature, on its part, has to lay down a broad policy framework and mandate it into a binding rule of conduct. The task of fleshing out the legislation is performed by subordinate legislation. SEBI as the expert has to regulate the frictions in and foibles of those engaged in the stock market. After all, the law envisages a role for SEBI to guard against the dangers when the rubber meets the road. Where an expert body is the maker of delegated legislation, the experience which it gains particularly in areas such as financial administration and resource allocation, enables it to

cope with myriad different situations which may emerge in the practical implementation of legislation. It is left to the delegate of the legislature to find answers to strategies which are utilized to defeat the norms laid down by the law, in order to secure public interest. This is perhaps best exemplified in areas of financial regulation of the securities market where subordinate legislation has to continuously evolve to keep pace with the challenges thrown up by the financial environment and the rapidly changing economic landscape. The reason why courts grant a degree of autonomy and discretion to the financial regulator is because of the realization of the enormous challenges before the regulator on designing regulatory measures and to continuously update them in the light of experiences gained, challenges presented and developments envisioned for the future. So long as the regulator has kept within the bounds of the statute, the court would defer to its expertise. Finally, as a Bench of seven learned Judges of the Supreme Court held in **R.S. Joshi etc. Vs. Ajit Mills Ltd. & Anr.[26]:**

> "...A law has to be adjudged for its constitutionality by the generality of cases it covers, not by the freaks and exceptions it martyrs..."

Now, to Article 19 (1) (c).

In **All India Bank Employees' Association Vs. The National Industrial Tribunal (Bank Disputes), Bombay, & Ors.[27]**, a bench of seven learned Judges of the Supreme Court, while interpreting Article 19 (1) (c), held that:

> "...It is one thing to interpret each of the freedoms guaranteed by the several Articles in Part III in a fair and

26 AIR 1977 SC 2279
27 AIR 1962 SC 171

> liberal sense, it is quite another to read each guaranteed right as involving or including concomitant rights necessary to achieve the object which might be supposed to underlie the grant of each of those rights, for that construction would, by a series of ever expanding concentric circles in the shape rights concomitant to concomitant rights and so on, lead to an almost grotesque result."

The same view was reiterated in a judgment of a constitution Bench of the Supreme Court in **M/s. Raghubar Dayal Jai Parkash Vs. Union of India & Ors.**[28]:

> "... An application for the recognition of the association for the purpose of functioning under the enactment is a voluntary act on the part of the association and if the statute imposes conditions subject to which alone recognition could be accorded or continued, it is a little difficult to see how the freedom to form the association is affected unless, of course, that freedom implies or involves a guaranteed right to recognition also. Could it be contended that there is a right in the association guaranteed by the Constitution to obtain recognition?"

The Supreme Court held that while right to form an association is a fundamental right guaranteed by Article 19 (1) (c) of the Constitution, the right to recognition is not. The right to obtain recognition is a consequence which emanates from the statute which provides for recognition. Consequently, where a legislation or subordinate legislation provides for recognition – recognition resulting in statutory entitlements recognised by

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28 AIR 1962 SC 263

the law – the right to obtain recognition is not a concomitant of the right to form an association under Article 19 (1) (c) of the Constitution.

Several decisions of the Supreme Court have construed the provisions of Article 19 (1) (c) of the Constitution since the early decisions in All India Employees Association and Raghubar Dayal Jai Prakash (supra). These include:

(i) **O.K. Ghosh Vs. EX Joseph[29];**

(ii) **Smt. Damyanti Naranga Vs. The Union of India & Ors.[30];**

(iii) **L.N. Mishra Institute of Economic Development and Social Change, Patna Vs. State of Bihar & Ors.[31];**

(iv) **Asom Rastrabhasa Prachar Samiti & Anr. Vs. State of Assam & Ors.[32];**

(v) **State of U.P. & Anr. Vs. C.O.D. Chheoki Employees' Cooperative Society Ltd. & Ors.[33];**

(vi) **Dharam Dutt & Ors. Vs. Union of India & Ors.[34]; and**

(vii) **Andhra Pradesh Dairy Development Corporation Federation Vs. B. Narasimha Reddy & Ors[35].**

In **O.K. Ghosh (supra)**, the Supreme Court considered the validity of Rule 4B of the Central Civil Services (Conduct) Rules, 1955, under which a government servant was prohibited from joining or continuing to be a member of a service association which had not obtained recognition of the government or whose recognition had been refused or withdrawn by government. The Supreme Court held as follows:

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29 AIR 1963 SC 812
30 (1971) 1 SCC 678
31 (1988) 2 SCC 433
32 (1989) 4 SCC 496
33 (1997) 3 SCC 681
34 (2004) 1 SCC 712
35 (2011) 9 SCC 286

> "It is not disputed that the fundamental rights guaranteed by Art. 19 can be claimed by Government servants. Art. 33 which confers power on the Parliament to modify the rights in their application to the Armed Forces, clearly brings out the fact that all citizens, including Government servants, are entitled to claim the rights guaranteed by Art. 19. Thus, the validity of the impugned rule has to be judged on the basis that the respondent and his co-employees are entitled to form Associations or Unions. It is clear that Rule 4-B imposes a restriction on this right. It virtually compels a Government servant to withdraw his membership of the Service Association of Government Servants as soon as recognition accorded to the said Association is withdrawn or if, after the Association is formed, no recognition is accorded to it within six months. In other words, the right to form an Association is conditioned by the existence of the recognition of the said Association by the Government. If the Association obtains the recognition and continues to enjoy it, Government servants can become members of the said Association; if the Association does not secure recognition from the Government or recognition granted to it is withdrawn, Government servants must cease to be the members of the said Association. That is the plain effect of the impugned rule."

In **Damyanti Naranga (supra)**, the Hindi Sahitya Sammelan Act 1962 of the State legislature did not merely regulate the administration of the affairs of the society. The Supreme Court held that what it did was to alter the composition of the society itself. The result of this change in composition was that members who had voluntarily formed the society were compelled to act in that Association with other members who were imposed

as members and in whose admission to membership they had no say. In that context, the Supreme Court held as follows:

> "The right to form an association, in our opinion, necessarily, implies that the persons forming the Association have also the right to continue to be associated with only those whom they voluntarily admit in the Association. Any law, by which members are introduced in the voluntary Association without any option being given to the members to keep them out, or any law which takes away the membership of those who have voluntarily joined it, will be a law violating the right to form an association. If we were to accept the submission that the right guaranteed by Article 19 (1) (c) is confined to the initial stage of forming an Association and does not protect the right to continue the Association with the membership, either chosen by the founders or regulated by rules made by the Association itself, the right would be meaningless because, as soon as an Association is formed, a law may be passed interfering with its composition, so that the Association formed may not be able to function at all. The right can be effective only if it is held to include within it the right to continue the Association with its composition as voluntarily agreed upon by the persons forming the Association."

In **L.N. Mishra Institute of Economic Development and Social Changes (supra)**, the Act of the State legislature took over an institute which had been formed by a society registered under the Societies Registration Act, 1860. Repelling the challenge to constitutional validity, the

Supreme Court distinguished the decision in Damyanti Naranga (supra) and held as follows:

> "The decision in Damyanti case (supra) has no manner of application to the facts of the present case. In that case, the composition of the Society was interfered with by introducing new members, which was construed by this Court as interference with the fundamental right of the Society to form association and to continue the same. In the instant case, the composition of the Society has not been touched at all. All that has been done is to nationalise the Institute of the Society by the acquisition of the assets and properties relating to the Institute. The Society may constitute its governing body in accordance with its rules without any interference by the Government."

In **Asom Rastrabhasa Prachar Samiti & Anr. Vs. State of Assam & Ors. (supra)**, the state legislation provided for the taking over of the Samiti which was a registered society. In that context, the Supreme Court held as follows:

> "In the present case the Government has taken the power under Section 3 to appoint a Board and the Government can appoint any one not connected with the Society at all to be in the Board. In the Act which was being examined by the Constitution Bench there were some restrictions on the nominations of persons although the persons were to be nominated by the Central Government but in the present Act it is left to the discretion of the Government to appoint the whole of the Board which will take place of not only 'the Managing Committee i.e. the Karyapalika but also the place of Byabasthapika Sabha which normally used to be an elected body."

In **C.O.D. Chheoki Employees' Cooperative Society Ltd.(supra)**, the Supreme Court, while repelling the challenge to certain provisions of the U.P. Cooperative Societies Act, 1965 and the Rules, held as follows:

> "Thus, it is settled law that no citizen has a fundamental right under Article 19(1)(c) to become a member of a Co-operative Society. His right is governed by the provisions of the statute. So, the right to become or to continue being a member of the society is a statutory right. On fulfillment of the qualifications prescribed to become a member and for being a member of the society and on admission, he becomes a member. His being a member of the society is subject to the operation of the Act, rules and bye-laws applicable from time to time. A member of the Society has no independent right qua the society and it is the society that is entitled to represent as the corporate aggregate. No individual member is entitled to assail the constitutionality of the provisions of the Act, rules and the bye-laws as he has his right under the Act, rules and bye-laws and is subject to its operation. The stream cannot rise higher than the source."

The earlier decisions of the Supreme Court were noticed in a later judgment in **Dharam Dutt & Ors. (supra)**, and the principles were summarized as follows:

> "(i) a right to form associations or unions does not include within its ken as a fundamental right a right to form associations or unions *for achieving a particular object or running a particular institution*, the same being a concomitant or concomitant to a concomitant of a fundamental right, but not the fundamental right itself. The associations or unions of citizens cannot further claim as a

fundamental right that they must also be able to achieve the purpose for which it has come into existence so that any interference with such achievement by law shall be unconstitutional, unless the same could be justified under Article 19 (4) as being a restriction imposed in the interest of public order or morality; (ii) A right to form associations guaranteed under Article 19 (1)(c) does not imply the fulfillment of every object of an association as it would be contradictory to the scheme underlying the text and the frame of the several fundamental rights guaranteed by Part III and particularly by the scheme of guarantees conferred by sub-clauses (a) to (g) of clause (1) of Article 19; (iii) While right to form an association is to be tested by reference to Article 19(1)(c) and the validity of restriction thereon by reference to Article 19(4), once the individual citizens have formed an association and carry on some activity, the validity of legislation restricting the activities of the association shall have to be judged by reference to Article 19(1)(g) read with 19(6). A restriction on the activities of the association is not a restriction on the activities of the individual citizens forming membership of the association; and (iv) A perusal of Article 19 with certain other Articles like 26, 29 and 30 shows that while Article 19 grants rights to the citizens as such, the associations can lay claim to the fundamental rights guaranteed by Article 19 solely on the basis of their being an aggregation of citizens, i.e. the rights of the citizens composing the body. As the stream can rise no higher than the source, associations of citizens cannot lay claim to rights not open to citizens or claim freedom from restrictions to which the citizens composing it are subject."

In that case, the Supreme Court considered the constitutional validity of the Indian Council of World Affairs Act, 2001. The Supreme Court noted that the Act dealt with only with the ICWA, a pre existing body. The new body took over the activities of the pre existing society for running the institution which too was known as the ICWA. Rejecting the challenge to constitutional validity, the Supreme Court held as follows:

> "So far as the society ICWA is concerned, it has been left intact, untouched and un-interfered with. There is no tampering with the membership or the governing body of the Society. The Society is still free to carry on its other activities. No membership of the old Society has been dropped. No new member has been forced or thrust upon the Society. The impugned legislation nominates members who will be members of the Council, the new body corporate, different from the Society. The pith and substance of the impugned legislation is to take over an institution of national importance. As the formation of the Society, which is a voluntary association, is not adversely affected and the members of the Society are free to continue with such association, the validity of the impugned legislation cannot be tested by reference to sub-clauses (a) and (c) of clause (1) of Article 19. The activity of the Society which was being conducted through the institution ICWA has been adversely affected and to that extent the validity of the legislation shall have to be tested by reference to sub-clause (g) of clause (1) of Article 19. The activity was of the Society and the Society cannot claim a fundamental right. Even otherwise, the impugned legislation is a reasonable legislation enacted in the interest of the general public and to govern an institution of national importance. It is valid."

In **Andhra Pradesh Dairy Development Corporation Federation (supra)**, the Supreme Court after adverting to the earlier decisions, held thus:

> "... the right of citizens to form an association is different from running the business by that association. Therefore, the right of individuals to form a society has to be understood in a completely different context. Once a co- operative society is formed and registered, for the reason that co-operative society itself is a creature of the statute, the rights of the society and that of its members stand abridged by the provisions of the Act. The activities of the society are controlled by the statute. Therefore, there cannot be any objection to statutory interference with their composition or functioning merely on the ground of contravention of individual's right of freedom of association by statutory functionaries."

The challenge was on the ground that the Andhra Pradesh Mutually Aided Cooperative Societies (Amendment) Act, 1995, violated Article 19 (1) (c). The Supreme Court held thus:

> "Members of an association have the right to be associated only with those whom they consider eligible to be admitted and have right to deny admission to those with whom they do not want to associate. The right to form an association cannot be infringed by forced inclusion of unwarranted persons in a group. Right to associate is for the purpose of enjoying in expressive activities. The constitutional right to freely associate with others encompasses associational ties designed to further the social, legal and economic benefits of the members of the association. By statutory interventions, the State is not

> permitted to change the fundamental character of the association or alter the composition of the society itself. The significant encroachment upon associational freedom cannot be justified on the basis of any interest of the Government. However, when the association gets registered under the Co-operative Societies Act, it is governed by the provisions of the Act and rules framed thereunder..."

These decisions clearly lay down that the fundamental right which is guaranteed under Article 19 (1) (c) of the Constitution, is to form an association. The fundamental right does not extend to guarantee that the objects, purposes or activities of the society which is so formed, shall not be regulated by law except on grounds set out in Article 19 (4). A close analysis of the decisions where the legislation was held to contravene Article 19 (1) (c) by the Supreme Court, would reveal that the vice of the legislation, was that the composition of the association which was formed in pursuance of the fundamental right under Article 19 (1) (c) was fundamentally altered. Thus, in Damyanti Naranga (supra), the existence of the original Sammelan was terminated, all existing members of the original Sammelan were made members of the new Sammelan and many outsiders were also made members. The new members who were enrolled were admitted without the consent of the original members. The erstwhile members were compelled to associate involuntarily with persons with whom they did not choose to associate. Similarly, in Asom Rashtrabhasa (supra), though the enactment was to meet a temporary contingency of taking over the management of the Prachar Samit, the Act failed to make any provision

for restoration of the elected body. New members were introduced into the Samiti, no norms were laid down for nominating the government nominees, and elected members were kept away from the control of the Samiti. This distinction was noted in the subsequent decision of the Supreme Court in **Dharam Dutt** (supra). On the other hand, what the decision in **C.O.D. Chheoki Employees Cooperative Society** (supra) emphasised is that where persons come together to associate under the umbrella of a legislation such as the Cooperative Societies Act, their rights are governed by the provisions of the statute and membership is subject to the Act, the rules and the bye-laws. Having chosen to seek the benefit of an association which is recognised by a State enactment, persons who choose to associate together by forming an entity which is recognised under the enactment, are necessarily governed by the rights, duties and obligations which are cast by the enactment. This distinction is emphasised in the judgment in the **Andhra Pradesh Dairy Development Corporation Federation** case.

The right to form an association cannot be infringed by a forced-imposition of persons in the association. By statutory intervention, the State cannot alter the composition of the association. But when a group of persons gets itself registered under a particular legislative enactment, it subjects itself to the discipline of the law and of the subordinate legislation. Hence, when an association of persons seeks legislative recognition for the purposes of carrying on a business or activity, the legislature can subject that business or activity to regulatory control. Legislation which has a nexus with the preservation of the public interest in the transparent and accountable

functioning of the activity or business is clearly permissible an does not violate Article 19 (1) (c).

The stock exchange is a vehicle created by individuals or entities which come together to provide a platform for transactions in securities. A regulation of the stock exchange is nothing but a regulation of the platform through which transactions in securities are implemented. Such regulation is permissible because there is a serious element of public interest involved in the activities of stock exchanges. Stock exchanges produce, as the Jalan Committee noted, a public good. The public has a vital interest in ensuring that the determination of the prices of securities and the transactional operations which are put through stock exchanges, are free from taint. Consequently, regulations such as those which have been framed by the SECC Regulations, insofar as they define the conditions for recognition, of minimum net worth, composition of the board of directors, dispersal of ownership and norms for governance, do not infringe the right under Article 19 (1) (c). The regulations govern the antecedents of the business or activity and do not infringe the right to form the association under Article 19 (1) (c). The challenge is, therefore, lacking in substance.

That apart, the Court must bear in mind the circumstance that the SECC Regulations do not have a direct or proximate impact on the associational right, if any, of the petitioners. The Uttar Pradesh Stock Exchange, as has been pointed out to the Court by the learned ASG, is a defunct stock exchange on which there has been no trading since 16 August 2010 or there about. SEBI has made it abundantly clear before the Court that there is no impediment for UPSEC Securities Limited, which is a

subsidiary of the stock exchange, to continue its functions. This is also evident from the terms of clause 4 of the circular issued by SEBI on 30 May 2012. The first petitioner is a society of traders or brokers allegedly engaged in trading with the second respondent which is a regional stock exchange at Kanpur. The stock exchange is defunct with little or no activity. Be that as it may, we have addressed the constitutional challenges squarely to analyze whether there is any substance in the submission.

Article 19 (1) (g) of the Constitution

The submission of the petitioners is that the regulations are excessively restrictive and would amount to a prohibition. It has been submitted that no regional stock exchange can meet the requirement of a net worth of Rs. 100 crore. The test of proportionality must be applied to a restriction on a fundamental right imposed under Article 19 (1)(g) of the Constitution and the least intrusive means must be adopted. The restrictions on ownership and on voting rights, it is asserted, is abhorrent to the fundamental right under Article 19 (1) (g). Similarly, the dispersal of ownership to the effect that 51 percent of the paid up equity capital be held by the public, it is claimed, would destroy the autonomy of the stock exchange. The provision that no person shall hold share unless he is a fit and proper person, is urged, to be vague and, therefore, destructive of the right to carry on business. Similarly, it has been submitted that the powers which SEBI has assumed over the inclusion of public interest directors would destroy the right to carry on business.

The decision of the Constitution Bench of the Supreme Court in **State of Madras Vs. V.G. Row**[36] is the locus classicus on the exposition of the test of reasonableness which must be applied when a law which imposes a restriction on a fundamental right guaranteed by Article 19 is questioned. The judgment of Chief Justice Patanjali Shastri, requires that in assessing the reasonableness of the restrictions, the Court must bear in mind several factors amongst them being:

(i) an examination of both the substantive and procedural aspects of the restrictive law;

(ii) the duration and extent of the restrictions;

(iii) the circumstances under which and the manner in which the imposition has been authorized;

(iv) the nature of the right alleged to be infringed;

(v) the underlying purpose of the restrictions imposed;

(vi) the extent and urgency of the evil sought to be remedied;

(vii) the disproportion of the imposition; and

(viii) the prevailing conditions at the time.

A person who challenges the law must, prima facie, show that the restriction is violative of the fundamental right, for if it is, then the burden lies upon the State to establish that the restriction is reasonable[37]

A considerable degree of reliance has been placed on the decision of the Supreme Court in **Global Energy Ltd. & Anr. Vs. Central Electricity Regulatory Commission**[38]. In that case, the Supreme Court considered the constitutional validity of clauses (b) and (f) of Regulation 6A of the Central

36 AIR 1952 SC 196
37 N.K. Bajpai Vs. Union of India & Anr., (2012) 4 SCC 653
38 (2009) 15 SCC 570

Electricity Regulatory Commission (Procedure, Terms and Conditions for Grant of Trading Licence and Other Related Matters) (Amendment) Regulations 2006. These regulations were framed in exercise of powers conferred by the Electricity Act, 2003. Under clause (b) and (f) of Regulation 6A, a disqualification was imposed in the grant of a licence for inter-State trading as an electricity trader if the applicant was not considered to be a fit and proper person for the grant of a licence for reasons to be recorded in writing. In determining whether the applicant is a fit and proper person, the Commission was empowered to take into account any consideration as it deems fit including but not limited to (i) the financial integrity of the applicant; (ii) competence; (iii) reputation and character; and (iv) efficiency and honesty. The Supreme Court held that a disqualifying statute must be definite and not ambiguous, uncertain or vague. The Supreme Court came to the conclusion that clauses (b) and (f) of Regulation 6A did not meet the test of reasonableness. Regulation 6A, it was emphasized, could not be justified as being in the interest of a consumer because a trader of electricity does not deal with consumers but is merely an intermediary between a generating company and a distribution licensee. As a matter of fact, the attention of the Supreme Court was drawn to the fact that the 'fit and proper person' criterion has been applied in the context of regulations framed by SEBI. The use of that concept in the SEBI regulations was distinguished by the Supreme Court on the ground that the purpose and object of those regulations was not similar to the regulations in question which were framed under the Electricity Act in regard to the grant of a

licence to a trader in electricity. This is clear from the observations of the Supreme Court:

> "Our attention has been drawn to some other legislations wherein the concept of `fit and proper person' had been applied, namely, Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004. We have not been shown as to how the purpose and object of the said Regulations can be said to be in pari materia with the Regulations in question. It must also be borne in mind that an elaborate public hearing process is provided for grant of licence in terms of Section 15 of the Act. Such an independent inquiry cannot be carried out de hors the statute. But the Parliament thought it fit to confer a hearing as regards public objection only.
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> The Consumer tariff is to be laid down by the Commission. How licensees would operate their business to the extent permissible under law should be subject to Regulation, which ordinarily should not be resorted to discourage private participation in the power sector. A trader of electricity does not deal with consumers; he is merely an intermediary between a generating company and a distribution licensee. The tariff that a distribution licensee will charge from its consumers is regulated. Even the margin that a trader can make is regulated. It is, therefore, not correct to contend that Regulation 6A is in consumer interest as it has not been shown how it will protect the consumer interest." (emphasis supplied).

Consequently, the judgment of the Supreme Court in **Global Energy Ltd.** does recognise that a criterion such as 'fit and proper person' may legitimately be applied and maybe reasonable in the context of a particular

statutory regulation while it may not be reasonable in another independent context. In the context of a licence for a trader in electricity, the Supreme Court was of the view that it was not a reasonable criterion to apply and was vague and indefinite. But the very judgment of the Supreme Court does recognise that the purpose and object of such a criterion may be quite distinct when it is applied in the context of financial regulation such as that of the securities market by SEBI, which is an expert regulator.

In **Union of India & Ors. Vs. S. Srinivasan**[39], the Supreme Court has enunciated that a rule which supplants any provision of the statute, becomes ultra vires. Similarly, in considering the vires of the regulation, it is necessary to consider the nature, object and scheme of the enabling Act, the power conferred under the rule, the concept of purposive construction and the discretion vested in delegated bodies.

We have prefaced our discussion of the constitutionality of the SECC Regulations by an analysis of the importance of the role which is ascribed to stock exchanges. Stock exchanges are, as the Jalan Committee observed, vital elements of the economic infrastructure of a modern economy. They provide a platform for investors to transact in securities. The probity and integrity of the functioning of stock exchanges deeply reflects upon the sense of confidence which investors have in the securities market. These investors are not just individual investors but institutional investors. Investments in the stock market are not confined to national boundaries but have a transnational character. Institutional decisions to invest in the stock market have a close and integral connection with the state of the economy,

39 (2012) 7 SCC 683

financial stability and the nature of regulatory governance. The market for securities has an integral connection with the allocation of capital and financial resources in a modern economy. Anything which affects the stability of the capital market has an impact on investor wealth and can severely imperil a stable financial order. Hence, the requirements which have been imposed by the SECC regulations must be assessed in the backdrop of the need to ensure transparency in the functioning of the securities market. Coupled with this is a felt necessity of ensuring the financial stability of stock exchanges, the dispersal of ownership and the avoidance of conflicts of interest which can jeopardize a stable and efficient market for securities.

Regulation 3 casts an obligation to obtain recognition from SEBI before a person can conduct, organise or assist in organizing a stock exchange. The circumstances which must be borne in mind in considering the grant of recognition are elucidated in Regulation 7(2). Each of those considerations is intended to ensure that the applicant would meet the requirements of the law and is possessed of adequate resources and expertise to put into place a complex structure that is involved in the establishment of a stock exchange. The Jalan Committee furnished a plausible and reasonable justification for imposing a requirement of a minimum net worth of Rs. 100 crores. The rationale is that a market infrastructure institution must be a properly capitalized entity in order, that its net worth is available as a last resort to meet an exigency and to ensure that it is able to remain as a going concern. The Jalan Committee noted that market infrastructure institutions, by their very nature, require huge long term sunk investment and net worth

is an important eligibility criterion. Providing a minimum net worth would ensure that only serious players enter into the arena. SEBI had already prescribed a net worth of Rs. 100 crore for depositories. Having regard to this background, it cannot be even postulated that a minimum net worth of Rs.100 crore is arbitrary. Once, it is held as a matter of principle, that the imposition of a minimum net worth requirement is not unreasonable or ultra vires, the fixation of a particular threshold in terms of value must lie in the expert determination of SEBI when it made the subordinate legislation. This must also apply to the manner in which the net worth is to be calculated. Nothing has been indicated before the Court to establish that the determination of the threshold or the manner of its computation is untenable and is so disproportionately high so as to constitute the very negation of the right to carry on business.

The restrictions which have been imposed in Chapter IV on the ownership of stock exchanges is with a rationale. SEBI was acting within its statutory realm in forming the view that the orderly development and functioning of the securities' market require that at least 51 percent of the paid up capital should be held by the public. The restrictions on holding share capital are intended to ensure that the shareholder does not use a position of dominance to place himself in a position which is liable to give rise to a conflict of interest. Dispersal of ownership can legitimately be an integral part of a policy which seeks to create a barrier to subversion.

We have carefully considered the challenge to the fit and proper person criterion. Regulation 20 (1) SECC Regulations stipulates when a person shall be deemed to be fit and proper. Undoubtedly, the considerations

which have been specified in Regulation 20 (1) (a) have a broad connotation, but the Court must be circumspect in striking down such a provision on the anvil of a scrutiny with a fine-tooth comb because so long as they fall within the general ambit of reasonableness, the regulation must be sustained. Financial integrity, reputation, character and honesty are matters which have a serious bearing on the objective, transparent and fair functioning of the securities market. Regulation 20 (1) (b) similarly specifies that the person should not have undergone any of the stated disqualifications. Though, the decision of SEBI on whether a person is fit and proper person has been made final, such finality would exclude the jurisdiction of a civil court. At the same time, a right of appeal is available under Section 15T (1) (a) of the SEBI Act to the Securities Appellate Tribunal to any person aggrieved by an order of SEBI made under the Act or the rules or regulations. When SEBI rejects an application for want of satisfaction of the fit and proper criterion, it must, in our view, record reasons which would be amenable to the appellate jurisdiction of the Tribunal under Section 15T. Recording of reasons would ensure that the exercise is not based on a subjective assessment but is based on an objective analysis.

In Chapter V, the regulations have provided for shareholder directors, public interest directors and the managing director. The need to have public interest directors is to ensure independence and objectivity in the functioning of the governing board of a recognized stock exchange. The ratio between shareholder directors and public interest directors, is again designed to ensure a sense of balance in the governing board. The Jalan

Committee while being of the view that a trading member should not be on the governing board, recommended that an Advisory Committee can be constituted by the governing board which would comprise of its trading members. The Advisory Committee would advise the governing board on non regulatory and operational matters including product, design, charges and levies. We find that the provisions which are contained in Chapter V are unexceptionable and cannot be held ultra vires.

Nearly 54 years ago, while delivering a judgment of the Constitution Bench in **Madhubhai Amathalal Gandhi Vs. Union of India**[40]**,** Mr. Justice Subba Rao (as the learned Chief Justice then was) emphasized the role and importance of a stock exchange in the following observations:

> "...The history of stock exchanges in foreign countries as well as in India shows that the development of joint stock enterprise would never have reached its present stage but for the facilities which the stock exchanges provided for dealing in securities. They have a very important function to fulfill in the country's economy. Their main function, in the words of an eminent writer, is "to liquify capital by enabling a person who has invested money in, say, a factory or a railway, to convert it into cash by disposing of his share in the enterprise to someone else". Without the stock exchange, capital would become immobilized. **The proper working of a stock exchange depends upon not only the moral stature of the members but also on their calibre... If the stock exchange is in the hands of unscrupulous members, the second and third categories of contracts to buy or sell shares may degenerate into highly speculative transactions or, what is worse, purely gambling ones …**

40 AIR 1961 SC 21

> **These mischievous potentialities inherent in the transactions, if left uncontrolled, would tend to subvert the main object of the institution of stock exchange and convert it into a den of gambling which would ultimately upset the industrial economy of the country**."(emphasis supplied).

These sagacious words continue to be of resounding relevance even to the present times.

Hence and for the reasons which we have indicated, we have come to the conclusion that there is no merit in the challenge, which has been leveled by the petitioners to the SECC Regulations. The Regulations are not ultra vires SCRA. They do not supplant the SCRA or travel beyond the bounds which are set by the statute or rules made thereunder. There is no merit in the contention that the regulations muzzle the fundamental right guaranteed under Article 19 (1) (c) or infringe the right to carry on trade or business under Article 19 (1) (g). Having bestowed our careful consideration, we find no merit in the petition. No other challenge has been pressed.

The petition shall stand, accordingly, dismissed. However, in the circumstances of the case, there shall be no order as to costs.

May 23, 2014
AHA

(Dr. D.Y. Chandrachud, C.J.)

(Dilip Gupta, J.)