

# SEBI'S JURISDICTION TO DECIDE AUDITOR'S LIABILITY IN LIGHT OF THE *PRICE WATERHOUSE & CO.* ORDER OF 2019

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## ABSTRACT

The Securities and Exchange Board of India (SEBI) cannot adjudicate any matter unless the question as to its jurisdiction is decided on merits. A similar question arises while initiating a proceeding against Auditors to protect the interest of investors under section 11 of the Securities and Exchange Board of India Act, 1992. As per section 11(2)(b) of the Act, the SEBI has power to take measures against intermediaries associated with securities market in any manner. The aforesaid section provides the right to the SEBI to take remedial action against certain persons/entities to protect the interest of investors. To hold any auditors liable, it is necessary to determine whether they are covered under section 11 of the Act or not. Even if the auditors are included under the very section, can the SEBI encroach upon the power of Institute of Chartered Accountants of India (ICAI) that is a statutory body established by the Chartered Accountants Act, 1949 to pass an order against any auditors? In 2019, Special Appellate Tribunal (SAT), while deciding an appeal filed against the order of the SEBI against Price Waterhouse and Co., held that Auditors' gross negligence amounts to professional misconduct and is within the jurisdiction of the ICAI. While holding so, the SAT relied upon Bombay High Court (HC) judgment of 2010 where HC held that where there is an omission, not having the element of mens-rea, then the SEBI does not have any jurisdiction under section 11 of the SEBI Act. In case of *Bharjatiya Steel Industries v. Commissioner, Sales Tax, UP*,<sup>1</sup> it was held that if

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<sup>1</sup> *Bharjatiya Steel Industries v. Commissioner, Sales Tax, UP*, (2008) 11 SCC 617.

any discretion is vested in the authority while imposing penalty then intention of the legislature is always that mens-rea should be proved beyond a reasonable doubt. SAT also said that the directions by SEBI under these cases, were remedial and not punitive, and hence require mens-rea to be proved beyond a reasonable doubt. In this paper, the author deals with the question of jurisdiction of the SEBI to initiate proceedings against auditors, and whether such proceedings are civil or quasi-criminal, because, mens- rea is not required to be proved in criminal cases.<sup>2</sup> The author will also look at the requirement of *mens-rea* laid down in a recent SAT order, keeping in mind Bombay High Court Judgment.

## I. INTRODUCTION

Price Waterhouse & Co., a limited liability partnership firm in India registered with the Institute of Chartered Accountants of India (hereinafter '**ICAI**') was assigned with the task of auditing Satyam Computers Services Limited (hereinafter '**Satyam Computers**'). In the year 2009, the Securities and Exchange Board of India (hereinafter '**SEBI**') came to know through an email sent by the Chairman of Satyam Computers that the statements of the books of accounts of Satyam Computers for year 2000-2008, was not fair and true. SEBI, after conducting investigation issued a Show Cause Notice (hereinafter '**SCN**') Satyam Computers as to why directions under the Securities and Exchange Board of India Act, 1992 (hereinafter '**the SEBI Act**') was not to be issued against PWC. Against this SCN, writ petitions were filed by Price Waterhouse and some of its partners before the Bombay High Court. In brief, Bombay High Court held that the jurisdiction of SEBI will depend upon proof of evidence and not on preponderance of probability. If there is an omission without *mens-rea*, it cannot trigger the jurisdiction of SEBI

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<sup>2</sup> SEBI v. Sri Ram Mutual Funds, [2006] 68 SCL 216(SC).

however, it can trigger the jurisdiction of ICAI in the name of 'professional misconduct'.

This paper deals with the question of the jurisdiction of SEBI through a critical lens. Firstly, it is important to know whether SEBI has been vested with the power under section 11 of the Act to initiate proceeding against Auditors. And, if yes, then does it encroach upon the power vested with ICAI or are they in addition to those covered under the Chartered Accountants Act, 1949? Because, there is a specific Act<sup>3</sup> to regulate the behaviour of Auditors.

The direction given under section 11 of the Act is remedial in nature and in such cases a discretion is vested with SEBI to pass or not to pass an order against Auditors. However, the Supreme Court Held in a case that if an authority has discretion while imposing penalty, then *mens-rea* must be proved. This is because the intention of legislature is not clear through a plain reading of the statute.<sup>4</sup>

SEBI in 2018 passed an order against Price Waterhouse stating that there is no necessity to prove *mens-rea* while holding the aforesaid Auditors liable and passed some stringent orders against them. However, an appeal had been preferred Price Waterhouse against the said order of SEBI. The Special Appellate Tribunal (hereinafter 'SAT') while deciding the appeal in 2019 held that *mens-rea* must be established. And if there is

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<sup>3</sup> Chartered Accountants Act, 1949, No. 38, Acts of Parliament, 1949 (India).

<sup>4</sup> *Bharjatiya Steel Industries v. Commissioner, Sales Tax, UP*, (2008) 11 SCC 617.

an omission without *mens-rea* then it can be challenged before ICAI in the name of professional misconduct.

Again, the order of SAT is not final in nature and an appeal can be made by SEBI to the Supreme Court of India. And, we can observe a shift in the idea as to the requirement of *mens rea* while holding Auditors liable under SEBI Act, 1992.

## **II. POWER OF SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI) TO INITIATE A PROCEEDING AGAINST AUDITORS UNDER SEBI ACT, 1992**

Unless the jurisdiction of SEBI is decided, SEBI cannot adjudicate any matter on merit. SEBI can only come up with a direction for regulating securities market and not anything more. However, the matters relating to scams that relate to the shares of the company, creates cascading impact on the securities market.<sup>5</sup> It is very hard to believe that such a scam could have gone unnoticed by the Auditors of the Satyam Computers. Under the SEBI Act, the primary function of SEBI is to regulate the security market and, has the power to take preventive steps to protect the interest of investors. The Auditors are required to take due care while certifying the accounts and balance-sheets of any company because people dealing in the securities market largely depend upon these documents while deciding financial health of that company.<sup>6</sup> Even though,

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<sup>5</sup> Ravi Kadam, the learned Advocate General appearing for the respondents in *Price Waterhouse & Co. v. SEBI*, W.P. Nos. 5249 & 5256: 2010 SCC OnLine Bom 1197.

<sup>6</sup> Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India), § 277.

the power of Institute<sup>7</sup> and SEBI are very different, if any misconduct is found in connection with auditing of a listed company, SEBI may take appropriate steps for safeguarding the interest of the investors of such companies. When Auditors act as trustees of shareholders, it cannot be said that there is no relation between investors and Auditors in any manner. Here, the Auditors are statutory Auditors and are required to give a true picture as to the affairs of the company in accordance with the prescribed auditing guidelines.

***1. SEBI's power to issue direction against Auditors under SEBI Act, 1992.***

In order to decide the power of SEBI to issue direction against Auditors, it is necessary to have a glimpse of various relevant provisions of the Act.<sup>8</sup>

The SEBI Act has been enacted with the main aim to:<sup>9</sup>

1. Provide for the establishment of a Board for the protection of interests of investors dealing with securities;
2. for the protection and regulation of securities market; and
3. for matters connected therewith or incidental thereto.

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<sup>7</sup> Means Institute of Chartered Accountants of India as established under The Chartered Accountants Act, 1949, No. 38, Acts of Parliament, 1949 (India).

<sup>8</sup> Securities and Exchange Board of India Act, 1992, No. 15 of 1992, Acts of Parliament, 1992 (India).

<sup>9</sup> Securities and Exchange Board of India Act, 1992, No. 15 of 1992, Acts of Parliament, 1992 (India), Preamble.

On a plain reading of the provisions of Act<sup>10</sup> along with the preamble, it discloses the ambit of power vested with SEBI that should be enjoyed by it for the benefit of the investors. Therefore, SEBI can take any measures mentioned under Section 11(2). However, the said provision is only illustrative and not exhaustive and SEBI has the duty to “take such measures as it deems appropriate”. Hence, one can fairly say that the scope of provision is wide enough to include an Auditor, i.e. if his activities are detrimental to the interest of investors.

Section 11(2)(b) includes the term “such other intermediaries associated with the securities market”. Therefore, measures under Section 11(1) may be for registering and regulating these intermediaries. Though a duty has been casted upon Auditors to take measures to protect the interest of investors as it falls under the ambit of section 11 (2) (b) of the SEBI Act. SEBI, after considering the duty it is given under the statute, may take such measures as it deems appropriate. The words mentioned in the aforesaid provision are of wide scope and would therefore include, within its umbrella, a chartered accountant if its activities are contrary to the both, the investor’s interest and the securities market.

While exercising power under the very Act, SEBI cannot encroach upon the power vested with the Institute.<sup>11</sup> But, it is also important to note whether SEBI is trying to overreach its jurisdiction substantially or not. SEBI has powers to take remedial measures. An appropriate order can also

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<sup>10</sup> *Supra* note 5.

<sup>11</sup> *Supra* note 1.

be passed in the interest of investors.<sup>12</sup> An appropriate direction can also be passed to any person or class of person mentioned under section 12 or associated with the securities market.<sup>13</sup> Bombay High Court in its judgment in *Price Waterhouse & Co. v. SEBI*,<sup>14</sup> also held that section 11(1) of the SEBI Act empowers SEBI to enquire into and also to initiate proceedings in the matters like one in the question. In *SEBI v. Pan Asia Advisors*,<sup>15</sup> it was held that the paramount purpose on one hand is the protection of investor's interest and development of market on the other, "since the auditors issue audit reports for listed companies, amongst others, SEBI being the watch-dog of the securities market is entrusted with powers to go after intermediaries in the interest of the investors".

### III. REQUIREMENT AS TO *MENS REA*

Now it is well settled that the SEBI has the power to encroach upon the power of Institute<sup>16</sup> in the interest of investors. And it can hold the Auditors liable. However, can the Auditors be held liable in all the circumstances or is there some test to decide their liability? Some say that *mens-rea* is important to be proved while holding an Auditor liable. However, the position is still not settled. This paper attempts to explain the requirement of *mens-rea* through a series of cases.

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<sup>12</sup> *Supra* note 5, § 11(4).

<sup>13</sup> *Supra* note 5, § 12B.

<sup>14</sup> *Price Waterhouse & Co. v. SEBI*, W.P. Nos. 5249 & 5256: 2010 SCC OnLine Bom 1197.

<sup>15</sup> *SEBI v. Pan Asia Advisors*, (2015) 14 SCC 77.

<sup>16</sup> *Supra* note 4.

It was held in *SEBI v. Sri Ram Mutual Funds*,<sup>17</sup> that if there is contravention of the statutory obligation as contemplated by the Act and regulations, then penalty is attracted and consequently, the intention of parties is immaterial. A breach of civil obligation that attracts penalty does not require innocence to be proved before the imposition of penalty. In the present case,<sup>18</sup> the Supreme Court has examined section 15-D(b) and section 15-E of the Act and said that there is nothing that is required for *mens-rea* to be proved before imposition of penalty. In another case, SC held that where there is a discretion not to award any penalty, the question of *mens-rea* becomes relevant.<sup>19</sup> However, it has been observed that the Supreme Court in *Bharjatiya Steel Case* does not state anything contrary to the *Sri Ram Mutual Funds Case*.<sup>20</sup> The statute where no discretion is conferred upon adjudicating authority, *mens-rea* is imperative and are not required to be proved. The reason may be that various market players can plead ignorance of law and *mens-rea* to escape from liabilities. Unless the language of the statute suggests the discretion to be enjoyed by the adjudicating officer while levying penalty, it is wholly unnecessary to prove intention. Therefore, it becomes clear that necessity to prove *mens-rea* depends upon the wording of the statute. Imposing *mens-rea* into provisions mentioned under Chapter VIA of Act<sup>21</sup> is against the plain language of the statute and can frustrate the entire purpose to give tooth to SEBI.

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<sup>17</sup> *SEBI v. Sri Ram Mutual Funds* [2006] 68 SCL 216(SC).

<sup>18</sup> *Id.*

<sup>19</sup> *Supra* note 4.

<sup>20</sup> Adjudicating officers SEBI, *Inland printers limited case*, 2017.

<sup>21</sup> *Supra* note 5.



#### **IV. UNDERSTANDING THE REQUIREMENT OF *MENS REA* THROUGH RECENT SAT ORDER IN PWC CASE IN LIGHT OF THE BOMBAY HIGH COURT'S JUDGMENT, 2010.**

In the year 2019, SAT, while deciding the legality of SEBI's 2018 decision wherein it banned audit firm Price Waterhouse, based and restricted its enquiry only on the grounds of fraud and conspiracy and not on preponderance of probability. This led to the questioning of the findings of the Whole Time Members (WTM) of SEBI in year 2018, of misconduct, where it held that gross negligence inferred the fudging of accounts of Satyam. And the Act<sup>22</sup> and Regulations<sup>23</sup> did not consider *mens-rea* as an essential element to be proved.

Whole Time Members held that:

1. Entities or firms that are practicing as CA and are associated with Price Waterhouse shall not be engaged with issuance of any certificate, in any way, of audit of companies that are listed for two years.

2. Auditors<sup>24</sup> will not issue a certificate of audit or compliance certificate for three years.

3. Both the individual Auditors shall jointly and severally disgorge the wrongful gain along with the interest of 12% p.a.

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<sup>22</sup> SEBI (PFUTP) Regulations, Gazette of India, pt. II sec. 4, 2003.

<sup>23</sup> Individual Auditors, namely, S. Gopalakrishnan and Srinivas Talluri, shall not issue an audit certificate or any certificate of compliance with respect to a listed company for a period of three years.

<sup>24</sup> For the duration of 2000-07, the engagement partner was S. Gopalakrishnan and for 2007-08 was Mr. Srinivas Talluri.

4. Companies and intermediaries that are listed and are registered with SEBI will not engage any audit firm associated with Price Waterhouse network for the issue of any certificate to ensure compliance of provisions under various laws for a duration of exactly two years.

### ***1. The Bombay High Court's Judgment, 2010***

The issue giving rise to this appeal was that the company was assigned with the task of audit of Satyam Computers Services Limited (SCSL). The two engagement partners were employed for the purpose.<sup>25</sup> SEBI received an email disclosing that the entries in the books were not fair and true. SEBI after conducting an investigation issued a Show Cause Notice by exercising its power under the SEBI, Act, 1992. Against this SCN, writ petitions were filed in Bombay HC by Price Waterhouse and other CA firms along with their partners alleging that the SEBI is not empowered to issue SCN as the appellants are CA professionals covered under the ICAI Act.<sup>26</sup>

### ***2. Jurisdiction of SEBI under SEBI Act,1992***

As discussed earlier, SEBI has the jurisdiction to initiate proceedings against the Auditors in the interest of investors and the same has been supported through the interpretation of various provisions of the Act. However, such power comes with a caveat, that evidence on record should establish the question as to “jurisdictional fact”, before SEBI exercises any kind of jurisdiction under the under the Act against

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<sup>26</sup> *Supra* note 18.

Chartered Accountants.<sup>27</sup> The jurisdiction will purely depend upon the availability of evidence during enquiry. The court concluded that if no evidence will be available as to falsification, SEBI cannot come up with any direction.<sup>28</sup>

### 3. *Question of 'mens-rea'*

It was held that if any omission was not supported with *mens-rea*, then SEBI cannot issue any further direction. SEBI being a quasi-judicial body, has the power to look into the matter and decide whether any Chartered Accountants or particular firm plays any role to attract the attention of SEBI.

### 4. *SEBI's order 2018*

The finding of SEBI<sup>29</sup> was that *mens rea* is not relevant in criminal cases and is not required to be proved either under PFUTP Regulation or SEBI Act.<sup>30</sup> Thus, reliance on the judgment of the Bombay High Court was unnecessary by the applicants. The failure to ask for external confirmation of the fixed deposits, bank balances, and so on, without following requisite procedure as mentioned under Accounting Standards draws an inference as to gross negligence and accounts fudging. And in such cases *mens-rea* is not important to be proved. Under the PFUTP

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<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> SEBI v. Kanaiyalal Patel, (2017) 15 SCC 1.

Regulations, Fraud includes an omission without deceit also if it has the effect of inducing another person to deal with securities.<sup>31</sup>

### 5. *SAT order 2019*

SAT while deciding the issue largely relied upon the Bombay HC judgment of 2010 and held *mens-rea* should always be proved to hold an auditor liable under the SEBI Act. Therefore, court restricted its enquiry only under the head of fraud and conspiracy and did not include *mens - rea*. Because if there is no *mens-rea*, SEBI does not have the jurisdiction and it falls under the domain of ICAI.

Even though, PFUTP regulation applies only to the person who deal in securities, its applicability can extend to persons who either directly or indirectly, are associated with securities market. Admittedly, it includes Auditors also and, in order to make them culpable, fraud is needed to be proved on the production of evidence. If there is gross negligence while complying with AAS (*Accounting Standards*), it can only point to professional negligence and such misconduct can only be taken by ICAI.<sup>32</sup> The SEBI, as a regulator does not have any authority under SEBI laws.<sup>33</sup> Thus, all the powers given to SEBI under Sec. 11 and 11B are there to protect the investor's interest, development and regulation of market. Hence, measures to be adopted by SEBI is only remedial and never punitive. Creating an entry barrier while entering the market can be justified, however, banning them from practice of audit activities can

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<sup>31</sup> *Id.*

<sup>32</sup> Price Waterhouse & Co., Appeal No. 6 of 2018, SAT Order (2019).

<sup>33</sup> *Id.*

never be justified.<sup>34</sup> The order of SEBI was neither preventive nor remedial. Actually, it was in violation of Article 19(1)(g) of the Constitution of India and hence can be challenged before Supreme Court as a writ.

Another very important point made by SAT in 2019 was that the partner firms were not Auditors that are statutory in nature and not in any way engaged in audit of the books of Satyam Computers. Any evidence of sharing of revenue between them were also not available. Misconduct committed by one partner can never be held as liable as there is no *mens-rea*, Auditors cannot be held as responsible. Even though professional negligence is evident on the part of auditors, it only triggers the jurisdiction of ICAI as they failed to comply with minimum degree of care.<sup>35</sup>

## V. CONCLUSION WITH SUGGESTIONS

After the above discussions, it is evident that the term 'any other person' under section 11 includes Auditors also. And therefore, SEBI has the jurisdiction to pass an order against them in the interest of the securities market and investors attached to it. SEBI can encroach upon the powers of ICAI only when interest of investors is involved subject to proof of evidence. Bombay High court has clearly laid down that SEBI has power to initiate a proceeding against Auditors.

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<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

It has also been shown in the present paper that *mens-rea* should be proved only in cases where discretion is vested with the authorities while imposing penalty. In wholly criminal cases, no discretion is vested with the authorities. But the power vested with SEBI, under section 11 is remedial and not punitive, it is quasi criminal in nature and requires *mens-rea* to be proved beyond a reasonable doubt. Where there is a scope for discretion, legislature intends for the proof of innocence.

Therefore, the recent SAT order clearly mentioned that SEBI in its order against Price Waterhouse & Co., was wrong while classifying this case as a criminal one and holding that *mens-rea* is not an essential requirement. While doing so, it went against the findings of Bombay High Court in year 2010. Therefore, SAT, set aside the order of SEBI while holding that *mens-rea* needs to be proved to trigger the jurisdiction of SEBI. And, if it is not proved, it will only amount to 'professional misconduct' and will be enquired by ICAI.

It is very difficult to determine whether discretion is vested in authority or not because even though section 11 is remedial in nature but Chapter VIA of the SEBI Act provides for imposition of penalty in cases. And interpretation of Chapter VIA makes it clear as a whole that Auditors are also covered. Therefore, there is no clear test as to the proof of innocence and that is why the decision of SAT can also be challenged before Supreme Court.

In the year 2009, five-member disciplinary committee of ICAI took first step towards disciplinary action against the two partners of

Satyam Computers who were involved in the scam. A case was registered against the partners and information was sought against the firm.