

SEBI relies on Secretarial Audit Reports of 'suspected shell companies' for identifying grave lapses in Related Party Transactions

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Introduction

With an objective to curb black money in the Indian economy, the Government in the recent past has taken adequate measures and regulatory actions against the companies, promoters and directors. The Ministry of Corporate Affairs released the list of disqualified directors and also a list of de-registered companies. On the other hand, SEBI directed stock exchanges to take action against 331 listed companies. The objective of SEBI in taking action against such listed companies was to protect the interest of the investors and market, punish errant promoters / directors of the company, etc.

This article gives a judicial and regulatory background of imposing trading restrictions on 331 'suspected shell companies' (with necessary reference to the SEBI communication and SAT order). Then, there is a detailed case-study based discussion, wherein SEBI has called upon and relied on the Secretarial Audit Report of 'suspected shell companies' for indentifying the compliance level for related party transaction.

Basic Provisions relating to Secretarial Audit Report

Pursuant to sub-section (1) of section 204 of the Companies Act, 2013, every listed company and a company belonging to other class of companies as may be prescribed shall annex with its Board's Report (made in terms of sub-section (3) of section 134 of the Act), a Secretarial Audit Report, given by a company secretary in practice, in a prescribed form. Sub-section (2) of section 204 of the Act states that it shall be the duty of the company to give all assistance and facilities to the company secretary in practice, for auditing the secretarial and related records of the company. Sub-section (3) of section 204 of the Act provides that the Board of Directors, in their report (made in terms of sub-section (3) of section 134), shall explain in full any qualification or observation or other remarks made by the company secretary in practice in his report under sub-section (1) of section 204 of the Act.

Rule 9 of the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 relates to Secretarial Audit Report. Form MR – 3 relates to the format of such report. The secretarial auditor is required to report based on the books, papers, minute books, forms and returns filed and other records maintained by the company. In the Report, the Practicing Company Secretary is required to state that during the audit period, the company has proper board process and compliance mechanism in place to the extent. The Secretarial Audit Report

* ACS. The views expressed are personal views of the author and do not necessarily reflect those of the Institute.



can be qualified by the Practising Company Secretary in case of non-compliance of provisions of the relevant law.

SEBI's action in imposing trading restrictions on suspected 'shell companies'

On August 7, 2017, the Indian Capital market regulator – SEBI directed stock exchanges to take action against 331 listed companies. In a letter, SEBI stated that Ministry of Corporate Affairs has identified a list of 331 listed companies as suspected 'Shell Companies' for initiating necessary action under securities laws. SEBI directed stock exchanges to take following measures:

- (i) Trading in such securities shall be placed in Stage VI of Graded Surveillance Measures ('GSM') with immediate effect, whereby trading shall be permitted only once a month under trade to trade category,
- (ii) Shares held by the promoters and directors in such listed companies shall be allowed to be transferred by depositories only upon verification by concerned exchanges,
- (iii) Promoters of the company shall not be allowed to transact in the security except to buy until verification of credential/fundamental by Exchanges is complete,
- (iv) SEBI further directed the stock exchanges to initiate a process of verifying the credentials/fundamentals of such companies,
- (v) SEBI directed stock exchanges to appoint an independent auditor to conduct audit of such listed Companies. and if necessary, even forensic audit,
- (vi) On verification, if the stock exchanges do not find any appropriate credentials/fundamentals about existence of company, the stock exchanges shall initiate proceedings for compulsory delisting against the company.

SAT's (interim) breather to suspected 'shell companies'

Securities Appellate Tribunal granted¹ stay on SEBI's communication directing stock exchanges to place J. Kumar Infraprojects Ltd. and Prakash Industries Ltd. (Appellants') in Stage VI of GSM. SEBI's referred Supreme Court's ruling in NSDL Vs SEBI² and submitted that the communication was an administrative direction issued to Stock Exchanges and therefore SAT had no jurisdiction to entertain appeals. SAT interpreted SEBI's communication and stated that "*Communication is not a general direction given by SEBI to the three stock exchanges in the interests of investors or securities market as contemplated under Section 11(1) of SEBI Act, but a specific direction given in respect of only 331 listed companies which MCA suspected to be shell companies*". SAT held that the SEBI's communication which prejudicially impairs the rights and obligations of Appellants, its promoters and directors would fall in the category of 'quasi judicial order' and hence appealable before SAT under section 15T of SEBI Act.

SAT upheld Appellants' submission that letter addressed (dated June 9, 2017) by Ministry

1. J. Kumar Infraprojects Ltd. Vs SEBI & Ors. Appeal No. 174 of 2017, Prakash Industries Ltd. Vs BSE Limited & Ors. Appeal No. 173 of 2017. Order dated August 10, 2017.
2. (2017) 5 SCC 517.



of Corporate Affairs merely required SEBI to investigate as to whether 331 Companies, named therein which were suspected to be 'Shell Companies', were in fact 'Shell Companies' and whether the said companies had any credentials/ fundamentals. SAT observed that SEBI passed the order without any investigation, opined that *"Even if letter of MCA was considered by SEBI to be a direction given for implementation without investigation, very fact that SEBI took nearly 2 months to comply with the directions given by the MCA clearly shows that there was no urgency in issuing the impugned communication without even investigating the credentials/ fundamentals of those companies"*.

Below case studies will help you understand the importance of Secretarial Audit Report in understanding and identifying the grave lapses in related party transactions by the 'suspected shell companies'.

- (1) *SEBI relied on Secretarial Audit Report for flagging non-compliances of related party transactions* : After an opportunity of personal hearing was granted to Trinity Tradelink Ltd.³ ('TTL'), following issues were before SEBI for consideration: (i) Whether there is prima facie evidence of misrepresentation including of its financials and/or its business and possible of violation of SEBI's Listing Regulations by TTL, (ii) Whether there is prima facie evidence that TTL is misusing the books of accounts / funds including facilitation of accommodation entries to the detriment of minority shareholders. SEBI observed that TTL had huge Trade Receivables and Trade Payables in FY 2015-16 & 2016-17, but TTL or its Authorized Representatives provided only a list of sundry creditors and debtors for FY 2016-17, without any supporting documents/ ageing analysis. SEBI referred the Secretarial Audit Report (in the Annual Report for 2015-16), noted that TTL entered into related party transaction for which prior board approval was not taken in manner prescribed in Rule 15 of Companies (Meeting of Boards and its Powers) Rules, 2014. SEBI opined that *"This prima facie raises concern as to whether the transactions were executed in the interest of shareholders"*. As TTL failed to provide any documentary support for sales agreements/ contracts/ orders received, SEBI observed that *"There is a lack of documents to substantiate the transactions entered into by the company and establish the genuineness of those transactions. I also note that significant Related Party Transactions have been entered into without due process"*. SEBI observed that there is prima facie evidence of misrepresentation of business/ financials as well as of misuse of funds/ company's books of accounts and stated that *"the directors and KMPs have prima facie failed to discharge their fiduciary responsibility. The company is also liable for the prima facie violations observed and it is imperative that in the interest of investors, the financials of the company be independently audited to establish their genuineness"*. On the issue relating to misrepresentation by company and misuse of funds, SEBI stated that *"Persons who are in control of the company and the directors of the company are prima facie liable for action by SEBI and should not be permitted to exit the company at the cost of innocent shareholders"*. SEBI transferred trading in securities of TTL to T – Group of BSE. SEBI also appointed independent auditor to conduct forensic audit.
- (2) *SEBI directed Forensic Audit of 'shell company' based on misreporting of related party transactions & accommodation entries* : After an opportunity of personal hearing was granted to JMD Ventures Limited⁴ following issues were before SEBI for consideration:

3. SEBI Order dated September 13, 2017, WTM/MPB/ISD/ 25/2017.

4. SEBI Order dated September 14, 2017, WTM/MPB/ISD/ 26/2017.



- (i) Misrepresentation of financials and/or business of company, (ii) Misuse of books of accounts / funds including facilitation of accommodation entries, if any. Based on documents and oral submissions, SEBI observed misreporting of related party transactions and dealings of the company with or through directors leading to prima facie evidence that company has misrepresented its transactions. SEBI opined that *"there is prima facie evidence of misrepresentation of business/financials as well as of misuse of funds/ the books of accounts of the company. The directors & KMPs have therefore prima facie failed to discharge their fiduciary responsibility. The company is also liable for the prima facie violations observed and it is imperative that in the interest of investors, the financials of the company be independently audited to establish their genuineness"*. SEBI opined that persons who are in control of the company and the directors of the company are prima facie liable for action and should not be permitted to exit the company at the cost of innocent shareholders. SEBI permitted trading in securities of the company, however directed the stock exchange to appoint an independent auditor for forensic audit.
- (3) *SEBI directed Forensic Audit based on unexplained trade receivables with related parties:* After an opportunity of personal hearing was granted to Jaisukh Dealers Limited⁵ (JDL), following issues were before SEBI: (i) Misrepresentation including of financials and/or business of JDL, (ii) Misuse of the books of accounts / funds including facilitation of accommodation entries. SEBI perused financial statements and observed that value of inventory was overstated by Rs. 1.8 crores leading to the prima facie evidence that JDL has misrepresented value of its inventory of shares/financials. SEBI perused the financial statements, affidavit of director and JDL's submissions. SEBI noted that JDL has failed to provide explanation and clarify the reason for director's disclosure of self-declared income of Rs. 1 crore as earned from accommodation entries. SEBI opined that there is a strong suspicion of misuse of books of accounts/funds of JDL. The market watchdog, SEBI, noted that JDL did not submit any underlying contract and whether it had Related Party Transaction outstanding as Trade Receivables as on March 31, 2017. JDL also failed to provide Secretarial Audit Report, on which SEBI opined that *"Failure on the part of the company to provide documentary support despite specifically asking for the same indicates that the company is neither able to establish the genuineness of these transactions nor that the transactions were in the interest of the public shareholders"*. SEBI directed the stock exchanges to conduct forensic audit of JDL.
- (4) *SEBI relied on Secretarial Audit Report for verifying related party transactions, observed grave lapses in broad approval process :* After an opportunity of personal hearing was granted to Newever Trade Wings Limited⁶ (NTWL), following issues were before SEBI: (i) Misrepresentation including of financials and/or business of NTWL, if any, (ii) Misuse of books of accounts / funds including facilitation of accommodation entries, if any. SEBI noted that: (i) Non-executive director of NTWL had provided accommodation entries, directly or indirectly, (ii) NTWL had failed to submit any documentary evidence like business contracts/sale agreements with customers/suppliers, (ii) NTWL failed to submit full details of Loans & Advances granted during 2016-17 (i.e. signed contracts

5. SEBI Order dated October 11, 2017. WTM/MPB/ISD/61/2017.

6. SEBI Order dated September 21, 2017, WTM/MPB/ISD/ 34/2017.



between parties and corresponding bank statements showing movement of funds). SEBI referred Secretarial Audit Report for FY 2015-16, noted that NTWL had taken loans from companies in which directors are common, the company has granted interest free short term advances to related party but has failed to obtain approval in accordance with Rule 15 of Companies (Meeting of Boards and its Powers) Rules, 2014). While relying on Statutory Auditor's comment that NTWL has not established Internal Financial Control, SEBI opined that "*Prima facie evidence on the misrepresentation by the company and misusing of books/funds including facilitation of accommodation entries, the persons who are in control of the company and the directors of the company are prima facie liable for action by SEBI and should not be permitted to exit the company at the cost of innocent shareholders*". Accordingly, SEBI directed independent forensic audit.

In the above 4 case laws, SEBI has directed forensic audit of a listed company by independent director. At this time, it will be pre-mature to comment on the outcome of the forensic audit, however, it is noteworthy that the Secretarial Audit Report issued by a Practising Company Secretary is considered by SEBI for the purpose of identifying: (i) Misrepresentation including of company's financials and/or its business, (ii) Misreporting of related party transactions and dealings of the company with or through directors, (iii) Failure to provide explanation and clarify the reason for director's disclosure of self-declared income as earned from accommodation entries, (iv) Loans from companies in which directors are common. The dependency of the Market watchdog / Securities Market Regulator itself is an indication that the Secretarial Audit and Secretarial Audit Reports is a value addition to all the stakeholders, including the regulators and Government. It is also worth appreciating the qualifications provided by respective Secretarial Auditor in the Report of the each company.
