

# SEBI'S 'CAPITAL' PUNISHMENT TO NSE, AN UNPRECEDENTED MOVE

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Capital Market & SEBI

The Securities and Exchange Board of India (SEBI) does not have a history of acting tough against stock exchanges, which are also the first level regulators for listed companies. There have been instances in the past when processes and procedures of exchanges have been a subject of regulatory probe, but more often than not, the bourses managed to get away with a censure or warning.

However, this changed last week. The capital markets watchdog ordered the NSE to disgorge money totalling Rs. 1,100 crore for not exercising proper due diligence while offering co-location services that allowed certain entities to gain access to information before others did.

Information asymmetry is not allowed under SEBI laws, and this violation led to the regulator acting in a manner hitherto not witnessed in the history of Indian capital markets.

SEBI has also taken strong action against the former and current top brass of the exchange as well, with two former chief executives — Ravi Narain and Chitra Ramkrishna — being directed to disgorge a part of their salaries and barred from being associated with any exchange or listed company.

The move assumes significance as NSE is the country's largest bourse in terms of market share in both equity and equity derivatives, where it has a virtual monopoly. It features among the top exchanges globally as well in terms of volume in the derivatives segment.

For the nine months ended December 31, 2018, NSE reported a consolidated net profit of Rs. 1,343 crore with revenues totalling Rs. 2,563 crore. Some of the trading segments of NSE registered a volume growth of over 50% in the period.

## Lot at stake with NSE

Simply put, a lot in terms of money and market safety and efficiency is at stake when it comes to NSE.

Hence, the conduct of the exchange in terms of its people and procedures is largely expected to be like Caesar's wife, above suspicion.

While the SEBI action is unprecedented and welcomed by many in the market, it has also raised important questions, the foremost being the rationale of directing NSE to disgorge money at a time when neither the regulator nor the exchange knows who lost money in this game.

There have been two high profile instances in the past when SEBI came out with disgorgement orders. One was in the IPO irregularities scam and then in the Satyam matter.

In both matters, the regulatory probe clearly showed that investors lost money due to fraudulent activities done by certain entities. In the IPO scam, even cheques were issued to various retail individual investors that were believed to have suffered losses due to the fraud.

“SEBI itself is saying that there is no fraud in this matter, but then goes on to pass a

disgorgement order,” said a former SEBI official wishing not to be named.

## **Bad precedent**

“If there is no fraud, then you can’t say it was ill-gotten gain and hence ideally you shouldn’t tell an entity to disgorge the gains. Passing a disgorgement order for not exercising proper due diligence can set a bad precedent,” he added. Indeed, the watchdog has explicitly stated in its order that there is no sufficient evidence to say that fraud was committed.

“To sum up, even though sufficient evidence is not available before me to conclude that... NSE has committed a fraudulent and unfair trade practice... I find that it is established beyond doubt that NSE has not exercised the requisite due diligence...” said the 104-page order issued by SEBI.

“SEBI has tried to balance various interests,” said Sumit Agrawal, founder, Regstreet Law Advisors and a former SEBI law officer.

“The ultimate purpose of disgorgement is to pay back with interest those affected by the action (investors here), and not to credit SEBI’s IPEF. Without a plan as to how to identify investors who were harmed by securities law violations and disgorged funds may be distributed, the order has a litmus test before SAT on this legal issue,” he added. The disgorged amount will be credited to Investor Protection and Education Fund (IPEF), as per the SEBI order.

“Whether disgorgement can be asked from someone who is judged to be not fraudulent or collusive to beneficiaries who made ill-gotten gains and have not been asked to disgorge, will be a bone of contention,” Mr. Agrawal said.

Another issue that is being talked about in the market is that ever since the matter came out in the open, it was widely believed that a set of brokers — predominantly OPG Securities — made the most of the gains due to preferential access to information. OPG Securities and its directors have been barred from the market for five years, though the amount to be disgorged is only around Rs. 15 crore.

There are, however, those who believe that SEBI took the right approach and that this was a fit case for issuing a disgorgement order.

“Disgorgement orders are passed in cases where you are able to establish that money or gains were made in a manner in which it shouldn't have been made,” said another former SEBI official.

“If SEBI is able to identify the entities that lost money in the process, then it needs to disgorge the money to such entities or else the money can go to the Consolidated Fund of India. In this particular case, the money will go to the government fund,” he added.

## **Way forward**

It is widely believed that the best way forward for the stock exchange is to disgorge the money and move on instead of stretching the matter by challenging the order at the Securities Appellate Tribunal or the high court.

Incidentally, the exchange already has more than the required amount of money kept in a separate bank account in which — based on a SEBI directive — revenues from co-location services were being credited since September 2016.

“SEBI has directed that pending completion of investigation to the satisfaction of SEBI, all revenues emanating from co-location facility, including the transaction charges on the trades executed through co-location facility with effect from September 2016, be transferred to a separate bank account,” the NSE stated, as part of the notes with its financial statements.

As on December 31, 2018, the account had a balance of Rs. 1,994.77 crore, as per NSE filings. This probe was also the biggest overhang in NSE’s plans of going public to raise funds. So, clearing the matter by disgorging the money would pave the way for the exchange to get listed in the coming months.

***SEBI has tried to balance various interests***

***Sumit Agrawal***

***Founder, Regstreet Law Advisors***

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