

# REPORT

JOINT COMMITTEE  
ON  
STOCK MARKET SCAM  
AND  
MATTERS RELATING THERETO

(THIRTEENTH LOK SABHA)

(VOLUME I – REPORT)

*Presented to Lok Sabha on 19 December, 2002  
Laid on the Table of Rajya Sabha on 19 December, 2002*



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\*Printed separately-Volume II.

\*\*Not printed. Five copies placed in Parliamentary Library.

COMPOSITION OF THE JOINT COMMITTEE ON STOCK MARKET SCAM  
AND MATTERS RELATING THERETO

Shri Prakash Mani Tripathi — *Chairman*

MEMBERS

*Lok Sabha*

2. Shri Mani Shankar Aiyar
3. Smt. Margaret Alva
4. Shri Vijayendra Pal Singh Badnore
- \*5. Shri Raashid Alvi
6. Shri C. Kuppusami
7. Shri Jagannath Mallik
8. Shri Rupchand Pal
9. Shri P.H. Pandian
10. Shri Pravin Rashtrapal
11. Shri S. Jaipal Reddy
12. Kunwar Akhilesh Singh
13. Shri Maheshwar Singh
14. Shri Prabhunath Singh
15. Shri Kirit Somaiya
16. Shri Kharabela Swain
17. Shri K. Yerrannaidu
- \*\*18. Shri C.P. Radhakrishnan
- \*\*19. Shri Srichand Kriplani
- \*\*\*20. Shri Anant Gudhe

*Rajya Sabha*

21. Shri S.S. Ahluwalia
22. Shri Nilotpal Basu
23. Shri K. Rahman Khan
24. Shri Praful Patel
25. Shri Kapil Sibal
26. Shri C. Ramachandraiah
27. Shri C.P. Thirunavukkarasu
28. Shri Prem Chand Gupta
29. Shri Amar Singh
- @30. Shri Lalitbhai Mehta

SECRETARIAT

- |                              |   |                             |
|------------------------------|---|-----------------------------|
| 1. Shri John Joseph          | — | <i>Additional Secretary</i> |
| 2. Smt. Paramjit Kaur Sandhu | — | <i>Joint Secretary</i>      |
| 3. Shri A. Louis Martin      | — | <i>Deputy Secretary</i>     |

\* Nominated w.e.f. 22.8.2001 vice Dr. Baliram resigned.

\*\* Nominated w.e.f. 26.2.2002 vice S/Shri Vijay Goel and Harin Pathak resigned.

\*\*\* Nominated w.e.f. 28.11.2002 vice Shri Anandrao Vithoba Adsul resigned. Shri Anandrao Vithoba Adsul had been nominated w.e.f. 9.8.2002 vice Shri Anant Gangaram Geete resigned.

@ Nominated w.e.f. 9.12.2002 vice Shri Vikram Verma resigned. Shri Vikram Verma had been nominated w.e.f. 7.5.2002 vice Shri Ramdas Aggarwal retired from Rajya Sabha.

## LIST OF ABBREVIATION USED IN THE REPORT

AACS	As Applicable to Cooperative Societies
ACB	Audit Committee of Board
ALM	Assets Liability Management
ACMM	Additional Chief Metropolitan Magistrate
ADs	Authorised Dealers
ADB	Asian Development Bank
ADRs	American Depository Receipts
AFI	Annual Financial Inspection
AGM	Annual General Body Meeting
AIFI	All India Financial Institutions
AIL	Annual Investment Ltd.
ALBM	Automated Lending and Borrowing Mechanism
AMCs	Asset Management Committees
AMC	Asset Management Company
AOPs	Association of Persons
ARs	Assured Return Schemes
ATL	Asia Today Ltd.
ATR	Action Taken Report
BFS	Board of Financial Supervision
BHL	Brentfield Holdings Ltd.
BLESS	Borrowing and Lending of Securities Scheme
BOI	Bank of India
BoT	Board of Trustees
BR	Bank Receipt
BR Act.	Banking Regulation Act
BSE	The Stock Exchange, Mumbai
BSPL	Biyani Securities Private Ltd.
CAMELS	Capital Adequacy, Asset Quality, Management Earnings Liquidity System & Controls
CBI	Central Bureau of Investigation
CBDT	Central Board of Direct Taxes
CCBL	City Cooperative Bank Ltd.
CCL	Century Consultants Ltd.
CD	Certificate of Deposit

CDSL	Central Depository Securities Ltd.
CEO	Chief Executive Officer
CIS	Collective Investment Scheme
CLB	Company Law Board
CMD	Chairman and Managing Director
CM	Capital Market
CMM	Chief Metropolitan Magistrate
COB	Committee of Board
COP	Cash on Payout
CRC	Credit Rating Cell
CRCS	Central Registrar of Cooperative Societies
CRAR	Capital to Risk Assets Ratio
CRR	Cash Reserve Ratio
CRS	Compulsory Rolling Settlement
CSE	Calcutta Stock Exchange Association Ltd.
CSFB	Credit Suisse First Boston
CSL	Consortium Securities Ltd.
CSMS	Centralised Funds Management System
CSPL	Consortium Securities Private Ltd.
CSSB	Classic Share & Stock Broking
CVC	Central Vigilance Commission
CVO	Chief Vigilance Officer
DBOD	Department of Banking Operations & Development
DCA	Department of Company Affairs
DFIs	Development Financial Institutions
DGIT	Director General of Income Tax
DGM	Deputy General Manager
DHS	Delloittee Haskins & Sells
DICGC	Deposit Insurance and Credit Guarantee Corporation
DKB	Dresdner Kleinwort Benson
DNBS	Department of Non-Banking Supervision
DRF	Development Reserve Fund
DRS	Department of Banking Supervision
DSPE	Delhi Special Police Establishment
DTAA	Double Taxation Avoidance Agreement
DTAC	Double Taxation Avoidance Convention
DVP	Delivery Versus Payment
EC	Executive Committee
ECS	Electronic Clearing Services
ED	Executive Director

ED	Enforcement Directorate
EFT	Electronic Funds Transfer
EGM	Extraordinary General Body Meeting
EIL	European Investments Ltd.
EOW	Economic Offences Wing
EPN	Entry Point Norm
ERC	Equity Research Cell
ET	Executive Trustee
FCCB	Foreign Currency Convertible Bond
FCNR	Foreign Currency Non-resident
FDI	Foreign Direct Investment
FEICL	Far-East Investment Corporation Ltd.
FEMA	Foreign Exchange Management Act
FERA	Foreign Exchange Regulation Act
FGSB	First Global Stock Broking
FIs	Financial Institutions
FIIIs	Foreign Institutional Investors
FIPB	Foreign Investment Promotion Board
FM	Finance Minister
FR	Fresh Receipt
FS	Finance Secretary
FY	Financial Year
GDRs	Global Depository Receipts
GIC	General Insurance Corporation
GTB	Global Trust Bank
GTL	Global Telesystems Ltd.
HDFC	Housing Development Finance Corporation
HFCL	Himachal Futuristic Communications Ltd.
HLCC	High Level Coordination Committee
HICCFM	High Level Coordination Committee on Financial and Capital Markets
HPC	High Power Committee
HSBC	Hongkong and Shanghai Banking Corporation
IBA	India Banks Association
ICAI	Institute of Chartered Accountants of India
ICDs	Inter Corporate Deposits
ICE	Information, Communication and Entertainment
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India
IFI	Indian Financial Institution
IISF-97	Institutional Investors' Special Fund Unit Scheme-97

Interpol	International Police
IPC	Indian Penal Code
IPOs	Initial Public Offers
IT	Information Technology
IT	Income Tax
JWG	Joint Working Group
KIL	Kensington Investment Ltd.
KP	Ketan Parekh
LIC	Life Insurance Corporation of India
MCFS	Modified Carry Forward Scheme
MD	Managing Director
MEA	Ministry of External Affairs
MICR	Magnetic Ink Character Recognition
MIP	Monthly Income Plan
MIS	Monthly Income Scheme
MMCB	Madhavpura Mercantile Cooperative Bank Ltd.
MOBAA	Mauritius Offshore Business Activities Authority
MoF	Ministry of Finance
MSCS	Multi State Cooperative Societies
MTNL	Mahanagar Telephone Nigam Ltd.
NABARD	National Bank for Agriculture & Rural Development
NACM	Nicholas Applegate Capital Management
NASDAQ	National Association of Securities Dealers and Automated Quotation
NAV	Net Asset Value
NBFC	Non-Banking Financial Companies
NCAER	National Council of Applied Economic Research
NCD	Non-Convertible Debentures
NHB	National Housing Bank
NPAs	Non-Performing Assets
NRE	Non Resident External
NRI	Non Resident Indian
NSCCL	National Securities Clearing Corporation Ltd. (NSCCL)
NSDL	National Securities Depository Ltd.
NSE	National Stock Exchange
NUI	Numero Uno International
OCBs	Overseas Corporate Bodies
OSMOS	Off-site Monitoring & Surveillance System
OTCEI	Over the Counter Exchange of India
PDO	Public Department Officer
PGL	Pentamedia Graphics Ltd.

PIS	Portfolio Investment Scheme
P&L Account	Profit & Loss Account
PMO	Prime Minister's Office
PMS	Portfolio Management Scheme
PNs	Participatory Notes
POs	Pay Orders
POA	Power of Attorney
PR	Public Representative
PSUs	Public Sector Undertakings
PUC	Paid Up Capital
RBI	Reserve Bank of India
RCFS	Revised Carry Forward Scheme
RCL	Rafis Corporation Ltd
RCS	Registrar of Cooperation Societies
RDs	Regional Directors
ROCs	Registrar of Companies
RSSBL	Reliance Shares and Stock Brokers Ltd.
RTGS	Real Time Gross Settlement
RTGSS	Real Time Gross Settlement System
SAC	Sell-N-Cash
SAT	Securities Appellate Tribunal
SAIL	Steel Authority of India Ltd.
SBI	State Bank of India
SBI Caps	SBI Capital Markets Ltd.
SC(R) Act	Securities Contracts (Regulation) Act
SEBI	Securities and Exchange Board of India
SEC	Securities Exchange Commission (USA)
SENSEX	BSE Sensitive Index
SFMS	Structured Financial Messaging Solution
SGL	Subsidiary General Ledger
SGF	Settlement Guarantee Fund
SHCIL	Stock Holding Corporation of India
SHL	Symphony Holdings Ltd.
SIA	Secretariat for Industrial Assistance
SLR	Statutory Liquidity Ratio
SLS	Securities Lending Scheme
SR	Security Deposit
SROs	Self Regulatory Organisations
STL	Silverline Technologies Ltd.
SUS	Special Unit Scheme

TIFIL	Triumph International Finance India Ltd.
TORTS	Trial of Offences Relating to Transactions in Securities
TWS	Trader Work Station
UCBs	Urban Cooperative Banks
UK	United Kingdom
URR	Uniform Regulations & Rules
U/s	Under Section
US-64	Unit Scheme—64
UTI	Unit Trust of India
VFSL	Vivenasari Financial Services Ltd.
WDM	Wholesale Debt Market
WHL	Wakefield Holdings Ltd.
YOI	Yield on Investment
ZMWL	Zee Multimedia Worldwide Ltd.
ZTL	Zee Telefilms Ltd.

## INTRODUCTION

I, the Chairman of the Joint Committee on Stock Market Scam and Matters Relating Thereto, having been authorized by the Committee to submit the Report on their behalf, present the Report of the Committee.

2. The Committee constituted on 27.4.2001 were instructed to make a Report to Parliament by the end of Monsoon Session, 2001. As the Committee could not complete their work by the scheduled date, they sought four extensions, the last extension being upto the last day of the Winter Session, 2002.

3. S/Shri Vijay Goel, Harin Pathak, Anant Gangaram Geete, Anandrao Vithoba Adsul, and Vikram Verma resigned on their induction in the Union Council of Ministers. Dr. Baliram resigned from the Committee. Shri Ramdas Agarwal ceased to be a member of the Committee on his retirement from Rajya Sabha. The Committee place on record their appreciation of the valuable contribution made by them to the deliberations of the Committee.

4. A Sub-Committee of the Joint Committee consisting of the Chairman, JPC and eight other members viz., S/Shri Mani Shankar Aiyar, Kirit Somaiya, S.S. Ahluwalia, Nilotpall Basu, C. Ramachandraiah, Kapil Sibal, Amar Singh and C.P. Thirunavukkarasu were appointed on 11.10.2002 to draft the Report of the Joint Committee.

5. The Committee/Sub-Committee held 105 sittings in all. Of these, 7 sittings were held for technical briefing, 2 sittings were held for taking stock of the implementation of the previous Action Taken Report, 59 sittings were devoted for recording of evidence of various agencies/Ministries/departments and individuals, 17 sittings for in-house deliberations and 20 sittings by the drafting Sub-Committee. The total duration of the sittings of the Committee was 357 hours and 45 minutes. The Committee took evidence of two Ministers, two Ex-Ministers, regulatory agencies—SEBI, RBI and DCA, Investigative agencies—CBI, CBDD and Directorate of Enforcement, Ministries/Departments of Government of India, Banks including Cooperative Banks, Financial Institutions—IDBI and ICICI, Presidents and Executive Directors of selected Stock Exchanges, SHCIL and other individuals. The list of individuals and organizations whose representatives gave evidence before the Committee, is given in Annexure. A verbatim record of the oral evidence before the Committee running into more than 4100 pages, was kept.

6. The Committee undertook an on the spot visit to Kolkata and Mumbai from 10th July, 2001 to 12th July, 2001 to familiarize themselves with the actual working of the Stock Exchanges. During the visit, the Committee also held informal discussions with the representatives of Reserve Bank of India, Securities and Exchange Board of India, Investors Forum and Brokers.

7. The Committee considered the final draft of the Report at their sittings held from 3rd to 5th and on 10th December, 2002 and adopted the same unanimously.

8. The Minutes of the sittings of the Committee form Part III of the Report.

9. For facility of reference and convenience, the observations, conclusions and recommendations of the Committee are also given separately at the end of the Report.

10. The Committee wish to express their thanks to the Ministers, ex-Ministers, representatives of various other Ministries/Departments, Organisations and individuals for placing before them the material and information asked for by them in connection with the examination of the subject and for giving evidence before them.

11. A Special Cell under overall charge of Shri John Joseph, Additional Secretary and headed by Smt. P.K. Sandhu, Joint Secretary assisted the committee in their work. The other officers in the Cell included Shri A. Louis Martin, Deputy Secretary; Shri Ashok Kumar, Deputy Director; S/Shri M.K. Madhusudhan and Ajay Kumar Garg, Committee Officers; S/Shri C. Kalyanasundaram, V. Ganapathy and Raj Kumar, Reporting Officers and other supporting staff. The Committee were also assisted by Shri Ashutosh Dikshit of the Indian Revenue Service who was on deputation as Officer on Special Duty to the Committee. The Committee place on record their deep appreciation for the hard work, dedication and valuable assistance rendered to them by all the officers and staff.

NEW DELHI;  
December 12, 2002  
*Agrahayana 21, 1924 (Saka)*

**SRI PRAKASH MANI TRIPATHI,**  
*Chairman,*  
*Joint Committee on Stock Market Scam*  
*and Matters Relating Thereto.*

LIST OF ORGANISATIONS AND INDIVIDUALS WHOSE REPRESENTATIVES GAVE  
EVIDENCE/PLACED THEIR VIEWS BEFORE THE COMMITTEE

1. Reserve Bank of India
2. Madhavpura Mercantile Cooperative Bank Ltd.
3. Bank of India
4. Bank of Punjab Ltd.
5. Centurion Bank Ltd.
6. Nedungadi Bank Ltd.
7. Classic Cooperative Bank Ltd., Ahmedabad
8. Global Trust Bank
9. IndusInd Bank
10. ICICI Bank Ltd.
11. City Cooperative Bank Ltd., Lucknow
12. Central Registrar of Cooperative Societies
13. Registrar of Cooperative Societies, Gujarat State
14. National Federation of Urban Cooperative Banks
15. Industrial Development Bank of India
16. Ministry of Finance (Capital Market Division)
17. Ministry of External Affairs
18. Department of Company Affairs
19. Central Board of Direct Taxes
20. Enforcement Directorate
21. Central Bureau of Investigation
22. Securities and Exchange Board of India
23. Stock Holding Corporation of India Ltd.
24. National Securities Depository Ltd.
25. Central Depository Securities of India Ltd.
26. Unit Trust of India
27. National Stock Exchange
28. The Stock Exchange, Mumbai
29. Calcutta Stock Exchange
30. Institute of Chartered Accountants of India

31. Tamil Nadu Investors Association, Chennai
32. Midas Touch Investors Association, Kanpur
33. Ms. Sucheta Dalal, Spl. Correspondent, Times of India
34. Ms. Olga Tellis, Consultant Editor, Asian Age
35. Shri L.C. Gupta, Director, Society for Capital Market and Research Development
36. Shri Ajit Kumar Dey, Former President, Calcutta Stock Exchange
37. Shri T.N. Ninan, Editor, Business Standard
38. Shri Tapas Datta, Executive Director, Calcutta Stock Exchange
39. Shri R.H. Patil, Former Managing Director, National Stock Exchange
40. Shri G.V. Ramakrishnan, Ex-Chairman, SEBI
41. Shri C.R.L. Narasimhan, Dy. Editor, The Hindu
42. Shri S.S. Tarapore, Former Dy. Governor, RBI
43. Shri P.S. Subramanyam, Former Chairman, UTI
44. Shri G.S. Reddy, DGM, SEBI
45. Dr. E.A.S. Sarma, Former Secretary, Department of Economic Affairs
46. Shri Ketan Parekh, Broker
47. Shri Ramesh Chandra Nandlal Parikh, Former Chairman, MMCB
48. Shri Devendra Pandya, Former MD, MMCB
49. Shri Jagdish Pandya, Branch Manager, MMCB (Mandvi Branch, Mumbai)
50. Shri Anand Krishna Johari, Former Director, City Cooperative Bank Ltd., Lucknow
51. Shri Arvind Johari of Cyberspace Infosys Ltd.
52. Shri Gorakh N. Srivastava, Former CEO, City Cooperative Bank Ltd., Lucknow
53. Shri Shankar Sharma, Broker
54. Shri H.C. Biyani, Broker
55. Shri D.K. Singahania, Broker
56. Shri A.K. Poddar, Broker
57. Shri Jaswant Singh, Minister of Finance
58. Shri Yashwant Sinha, Minister of External Affairs
59. Shri P. Chidambaram, Former Finance Minister
60. Dr. Manhoman Singh, Former Finance Minister

# PART I

## CHAPTER I

### THE CONSTITUTION OF THE JOINT PARLIAMENTARY COMMITTEE

1.1 In the beginning of January 2001, the Sensex (the stock index of the Bombay Stock Exchange) was ruling around 4000. It peaked at 4437 on 15.2.2001, thereafter showing a downward trend and was at 4069 on 27.2.2001. The Nifty (the stock index of the National Stock Exchange) exhibited a similar trend. On 28.2.2001, the day of the presentation of the Budget of 2001-2002, the Sensex opened at 4070 and closed at 4247, a rise of 177 points. On 1.3.2001, the Sensex closed at 4271, a gain of 24 points. On 2.3.2001, after opening at 4323 and reaching an intra-day peak of 4321, the Sensex closed at 4095, registering a decline of 176 points and an intra-day decline of 246 points. Besides the volatility in the movement of the index, prices of certain scrips registered violent fluctuations. The Securities and Exchange Board of India (SEBI) instituted an investigation on 2.3.2001 which began with six broking entities and was subsequently expanded to cover the entire gamut of the scam. The matter of the sudden fall in the Sensex of the Bombay Stock Exchange, within a few days of the presentation of the Budget of 2001-2002 was raised in the Lok Sabha during Zero Hour on 7.3.2001. Members drew the attention of the government to the ongoing meltdown in the stock market, their apprehensions that there could be market manipulation, and that a major stock market operator had taken huge stock positions by misusing bank funds, thus putting bank depositors money at risk. Members were concerned that banks were in jeopardy and small investors were losing heavily. They were exercised about the ineffectiveness of the Securities Exchange Board of India (SEBI) and the possibility that the stock market had been manipulated. On 8.3.2001 and 9.3.2001, there were indications that the Calcutta Stock Exchange, the third largest exchange in the country, was facing problems for its pay-out on 10.3.2001 as some major brokers had defaulted on their pay-in obligations on 8.3.2001. The President of the Bombay Stock Exchange also resigned on 8.3.2001 in the face of allegations that he had obtained certain price sensitive information from the surveillance department of the Exchange on 2.3.2001. On 9.3.2001, there was a sudden rush of depositors wishing to withdraw their deposits at the Ahmedabad branches of Madhavapura Mercantile Cooperative Bank, the second largest bank in the state of Gujarat. The withdrawals increased steadily till 12.3.2001 and were fuelled by rumors that the bank had extended guarantees to Shri Ketan Parekh, a leading Mumbai based stockbroker, who had suffered huge losses in his share dealings. The bank closed down all its branches on the morning of 13.3.2001, ostensibly because it was no longer capable of meeting the run on the bank. The Sensex had fallen further to 3767 by 12.3.2001. On 13.3.2001, the leader of the principal opposition party in the Rajya Sabha moved a motion calling attention to the extreme volatility in the stock markets. A large number of speakers from all sides of the House took part in this debate. Members drew attention to the volatility in the stock markets and unhealthy practices like insider trading and rampant speculation. They pointed out that SEBI, the stock market regulator, had not kept a close watch on the market. Members also expressed the view that since SEBI was itself the main regulator, an inquiry by SEBI would not serve the purpose. Responding to the calling attention motion, the then Finance Minister stated that while fluctuations are normal in stock markets and should not be a matter of undue concern we should be vigilant with regard to any systemic risk or movements driven by any form of manipulation. He also stated that he has been assured by SEBI that there was no systemic risk to the market and there was no danger of payment crisis. Some members were of the view that the damage caused to the share market was of

such magnitude, that it needed a thorough inquiry and it was therefore suggested that a Joint Parliamentary Committee (JPC) should be constituted and report be submitted to Parliament within a proper time frame.

1.2 Taking note of the concern of the Members in both Houses of Parliament and after due deliberation and discussion, the Government moved a motion in the Lok Sabha, proposing to constitute a Joint Committee to inquire into the Stock Market Scam and matters relating thereto. The motion moved and adopted in the Lok Sabha on 26.4.2001 included the following members of the Lok Sabha (Appendix-I):—

1. Shri Mani Shankar Aiyar
2. Smt. Margaret Alva
3. Shri V.P. Singh Badnore
4. Dr. Baliram
5. Shri Anant Gangaram Geete
6. Shri Vijay Goel
7. Shri C. Kuppusami
8. Shri Jagannath Malik
9. Shri Rupchand Pal
10. Shri P.H. Pandian
11. Shri Harin Pathak
12. Shri Pravin Rashtrapal
13. Shri S. Jaipal Reddy
14. Shri Kunwar Akhilesh Singh
15. Shri Maheshwar Singh
16. Shri Prabhunath Singh
17. Shri Kirit Somaiya
18. Shri Kharabela Swain
19. Shri Prakash Mani Tripathi
20. Shri K. Yerrannaidu

1.3 The motion regarding appointment of the Committee concurred in by the Rajya Sabha on 26.4.2001 included the following members of Rajya Sabha (Appendix-II):—

1. Shri Ramdas Agarwal
2. Shri S.S. Ahluwalia
3. Shri Nilotpal Basu
4. Shri Prem Chand Gupta
5. Shri K. Rahman Khan
6. Shri Praful Patel
7. Shri C. Ramachandraiah
8. Shri Kapil Sibal
9. Shri Amar Singh
10. Shri C.P. Thirunavakkarasu

1.4 The Joint Committee was constituted on 27.4.2001, with Speaker, Lok Sabha appointing Lt. Genl. (Retd.) S.P.M. Tripathi from amongst the members as Chairman of the Joint Committee.

1.5 Thus, a Committee of 30 Members of Parliament was constituted as Joint Committee on Stock Market Scam and Matters relating thereto.

1.6 Shri Raashid Alvi was appointed to serve on the Committee with effect from 22nd August, 2001 consequent upon the resignation of Dr. Baliram from the Committee. Three Members of the Committee viz. Shri Vijay Goel, Shri Harin Pathak and Shri Anant Ganga Ram Geete resigned on their induction in the Union Council of Ministers. In their places, Shri C.P. Radhakrishnan and Shri Srichand Kriplani were appointed with effect from 26th February, 2002 and Shri Anand Rao Vithoba Adsul w.e.f. 9.8.2002 to serve the Committee Shri Anand Rao Vithoba Adsul resigned on his induction into the Council of Ministers. In his place, Shri Anant Gudhe was appointed to serve the Committee w.e.f. 28.11.02. Shri Prem Chand Gupta and Shri Amar Singh who ceased to be members of the Committee consequent on their retirement from Rajya Sabha with effect from 9th April, 2002 and 25th November, 2002 respectively were renominated to the Committee w.e.f. 7th May, 2002 and 9th December, 2002 after their re-election to Rajya Sabha. Shri Ramdas Agarwal retired from the membership of Rajya Sabha w.e.f. 9th April, 2002 and ceased to be member of the Committee. Shri Vikram Verma who was appointed in his place w.e.f. 7th May, 2002 resigned on his induction into the Union Council of Ministers. In his place Shri Lalitbhai Mehta was appointed w.e.f. 9th December, 2002

1.7 The terms of reference of the Committee were as follows:—

1. To go into the irregularities and manipulations in all their ramifications in all transactions, including insiders trading, relating to shares and other financial instruments and the role of banks, brokers and promoters, stock exchanges, financial institutions, corporate entities and regulatory authorities.
2. To fix the responsibility of the persons, institutions or authorities in respect of such transactions.
3. To identify the misuse, if any, of and failures/inadequacies in the control and the supervisory mechanisms.
4. To make recommendations for safeguards and improvements in the system to prevent recurrence of such failures.
5. To suggest measures to protect small investors.
6. To suggest deterrent measures against those found guilty of violating the regulations.

1.8 While the Committee was in session, The Unit Trust of India, (a financial institution established in 1964, under an Act of Parliament), the country's oldest and largest fund manager, announced on 2.7.2001 that it was suspending redemptions from its US-64 fund till the end of the year. UTI is the largest single investor in the stock markets, at that time controlling assets worth nearly Rs. 60,000 crore and its US-64 scheme accounted for nearly fifteen percent of the mutual fund industry's assets. The Chairman of the UTI was asked to resign on 3.07.2001. In a separate matter, the Central Bureau of Investigation (CBI) instituted a case against him and three other senior executives of UTI for causing wrongful loss to the UTI with regard to investments made by the UTI in subscribing to the shares of a company. Short duration discussions on the working of UTI were held in the Rajya Sabha on 24.7.2001, 25.7.2001,30.7.2001,31.7.2001,1.8.2001 and 2.8.2001 with special reference to the freeze on the sale and repurchase of units of US-64 scheme. On 2.8.2001 forty two notices for motion of adjournment were moved in the Lok Sabha, regarding

deliberate omissions and commissions on the part of various authorities due to which UTI's US-64 Scheme had been put in jeopardy causing a crisis of confidence among small investors. This motion was debated the same day and a demand was raised that another JPC should be set up to inquire into the affairs of the UTI. Subsequently, on 3.8.2001 the Minister of Parliamentary Affairs mentioned that a JPC was already looking into all the happenings in the stock market and that its terms of reference had been drafted with the consensus of the House, in consultation with the leaders of various political parties. He stated that the same JPC could also address the concerns of members about the UTI. He requested the Speaker that as suggested by the Deputy Leader from the principal Opposition party, a meeting of leaders of political parties might be called in which the Chairman of the current JPC may be present. This meeting could deliberate whether the same Joint Parliamentary Committee should look into the affairs of UTI.

1.9 Accordingly, the Honourable Speaker called a meeting in his Chamber on 3.8.2001, in which leaders of all the major parties in Parliament and the Chairman of the current JPC were present. After due discussion, it was decided by the Honourable Speaker that as the on-going Joint Parliamentary Committee was already looking into the share market portion of the working of the UTI, the scope could be further enlarged and the same Committee may inquire into the entire working of the UTI with special reference to the freeze of all sale and repurchase of units of the US-64 scheme. This decision was incorporated in the following announcement of the Honourable Speaker, which he made in the Lok Sabha on 3.8.2001:

"I had called a meeting of the leaders of different parties in my chamber today to discuss the matter relating to UTI. The Chairman of the JPC on Stock Market Scam and Matters Relating thereto was also present. After hearing the views of all parties, particularly the statement of the Chairman, it was decided that all issues relating to UTI including the issues discussed in the House would be considered by the JPC. The JPC will now proceed accordingly."

1.10 Though the scope of the inquiry was enlarged on 3.8.2001, the Joint Parliamentary Committee had already commenced their sittings from 14.5.2001. This scam in some aspects differed from the previous scam inquired in 1992 by the Joint Committee set up to enquire into Irregularities in Securities and Banking Transactions. The earlier inquiry mainly concerned misuse of public funds through various securities transactions (in government bonds, bonds of Public Sector Undertakings and other instruments) aimed at illegally siphoning funds of banks and Public Sector Undertakings (PSU's) to select brokers for speculative returns. The mandate of the present JPC was, however, to go into irregularities and manipulations in capital market transactions and the role of banks, brokers and promoters, stock exchanges, financial institutions, corporate entities and regulatory authorities. They also had to go into the failures and inadequacies of the control and supervisory mechanisms besides suggesting measures to promote and protect the interests of small investors. However, the climate in which the present scam surfaced, shows some similarity with the last scam, which happened a good nine years ago. In sum this scam appeared to be less intensive but more extensive in as much as more institutions and players appeared to be involved.

1.11 The Report of the previous JPC to Enquire into Irregularities in Securities and Banking Transactions was presented to Parliament on 21.12.1993. Thereafter the government presented an Action Taken Report to Parliament on 25.7.1994 and its contents were debated in considerable detail. Based on the comments of opposition parties and after discussions with them, the government presented a revised Action Taken Report to Parliament on 20.12.1994. It is a source of concern to this Committee that a major scam has surfaced after all these measures, causing considerable damage to the capital market, the common investor and market sentiment. Among other things, such repeated scams lead to cynicism and a loss of faith in the system as various

sections of society start believing that stock markets are manipulated, banks are regularly defrauded and the regulators do not take their job seriously.

1.12 The unanimous view of the members of the Committee was that their recommendations would not be effective in deterring further scams unless they are properly implemented. In order to suggest a method for effective implementation, it was necessary to find out the deficiencies in the implementation of the last Report. The Committee were briefed on further developments relating to the Action Taken Report of the earlier JPC by among others, Ministry of Finance (MoF), Reserve Bank of India (RBI), Securities Exchange Board of India (SEBI), Department of Company Affairs (DCA), and Central Bureau of Investigation (CBI). Also, as the subject matter related to complicated financial procedures and practices of various entities connected with the working and regulation of stock market and banking transactions, the Committee decided that as a first step, members should be made familiar with the working of the system. Accordingly, technical briefings were organized. The Committee also had the benefit of hearing the views of experts from various sections of society about the present scam and what can be done to prevent future ones.

1.13 The Committee at their first sitting held on 14th May, 2001, deliberated upon the broad procedure to be adopted by the Committee for their working. The question whether the press be allowed to cover the proceedings of the Committee was considered and it was decided that the press need not be allowed to attend the sittings of the Committee and that the Chairman might brief the press after each meeting of the JPC.

1.14 Direction 99 of the Directions by the Speaker applicable to Financial Committees prohibits the Committees from calling a Minister before the Committee either to give evidence or for consultation in connection with the examination of estimates or accounts. However, the motion adopted by the House for the JPC provided that the Committee might, if need arises, in certain matters adopt a different procedure with the concurrence of the Speaker. In view of this, a specific request was made to the Hon'ble Speaker, Lok Sabha by the Chairman, JPC on 20th May, 2002 as decided by the Committee for permitting the Committee to call written information on certain points from the Minister of Finance and Minister of External Affairs. Hon'ble Speaker, Lok Sabha accorded the necessary permission on 1st June, 2002. Accordingly, the Committee called information in writing on certain points from the Ministers.

1.15 As there were still some points on which further clarifications were needed from the Ministers, the Committee felt at their sitting held on 17th September, 2002 that interaction with the Minister of Finance and the Minister of External Affairs would throw more light on the issues under consideration of the Committee. Accordingly, with the permission of the Hon'ble Speaker, Lok Sabha, the Committee took evidence of the Minister of Finance, Shri Jaswant Singh (on 13.11.2002) and the Minister of External Affairs, Shri Yashwant Sinha (on 26.11.2002).

1.16 The Committee also called information in writing and also took evidence of the two Ex-Ministers of Finance, Shri P. Chidambaram (on 14.11.2002) and Dr. Manmohan Singh (on 26.11.2002)

1.17 Direction 51 of the Directions by the Speaker prohibits holding sittings of Parliamentary Committees after the commencement of a sitting of the House and before 1500 hrs. on days when the House is sitting. Due to paucity of time and with a view to finalising and presenting the report of the Committee during the Winter Session of Lok Sabha 2002, the Committee with the permission of the Hon'ble Speaker, Lok Sabha and Hon'ble Chairman, Rajya Sabha held sittings of the Committee/Sub-Committee on 26, 28 and 29 November and 3 to 5 and 10 December, 2002 even during the prohibited timings under Direction 51 on the days when the House was sitting during Winter Session of Parliament.

## CHAPTER II

### OVERVIEW

2.1 Parliament, through a motion in the Lok Sabha on 26.4.2001, mandated this JPC to enquire into the stock market scam. This scam was distinct and different from the scam enquired into by a Joint Parliamentary Committee in 1992-93. While the enquiry into the earlier scam related to 'irregularities in securities and banking transactions', the present scam mainly relates to financial misconduct in the stock market. Both the scam enquired into in 1992-93 and the present one have some common features like the failure of some banks as also high volatility in the stock market.

2.2 The Committee were given an additional task after they had been constituted and started functioning. As announced by the Speaker, Lok Sabha on 3.8.2001, the Committee were further asked to look into all matters relating to the Unit Trust of India (UTI). This additional task to the Committee was necessitated by the freeze on resale of US-64 units by UTI in July 2001. Accordingly, the Committee enlarged their enquiry to include UTI in addition to the Stock Market Scam.

2.3 During the working of this Committee, simultaneous actions pertaining to the enquiry were initiated by the Regulatory agencies like SEBI, RBI and DCA. Information was gathered by the Committee from all these agencies through written questions, perusal of relevant departmental documents including files and depositions in person by heads/representatives of Banks, Regulatory bodies, Stock Exchanges, UTI and officials of Government departments. The Committee were also assisted by the present Finance Minister and his three immediate predecessors.

2.4 Flowing from the terms of reference were some of the questions that were discussed in-house by the JPC: Why do scams occur frequently? Are the rules and regulations obsolete or inadequate? Do regulatory authorities lack adequate power, or, are they deficient in implementation and vigilance? Do the stock exchanges follow laid-down guidelines and procedures? Are the managements of banks following the norms of accountability and corporate governance and are they running them according to guidelines laid down by the regulator? Should the stock market be self-disciplined and self-regulating or, should the regulators and the Government keep a close watch all the time? Have Government shown themselves alert to emerging problems? A recurring theme in the discussions of the Committee was how to arrive at recommendations that will minimise, if not deter, the possibility of a future scam.

### STOCK MARKET SCAM

2.5 The Regulatory framework has to be fashioned to cater for the changing economic scenario of the country. With liberalisation, the role of the government as a direct player is being progressively reduced. Earlier, the Government had considerable control over a large part of economic activity and acted as policy maker, regulator and service provider in several sectors. Efforts to separate these functions have been going on since 1991 and will have to continue. Whatever the functions of the Government with regard to the economy as a whole, the functions of Government as a policy maker have changed and will change as the economy

shifts towards more and more market-orientation. In the light of this development, the relationship between Government and the regulators has been changing, with a conscious effort at distancing Government from day-to-day regulation, augmenting the autonomy of Regulators and endowing them with statutory powers. At the same time, Regulators have been found wanting and they do not instil confidence in the investor. While it is for the executive and the Regulators to reconcile the growing autonomy of the Regulators with the imperatives of effective regulation to meet the requirements of a healthy capital market, the responsibility of the Ministry of Finance to Parliament for the financial health of the economy, including capital markets, must inform the institutions, mechanisms and procedures put in place to this end.

2.6 The liberalized economy is statutorily regulated by the Reserve Bank of India (RBI), the Securities Exchange Board of India (SEBI), the Department of Company Affairs (DCA) and others. These Regulators are represented, along with senior officers of the Ministry of Finance, in the High Level Coordination Committee for Capital Markets (HLCC), chaired by Governor, RBI. Although important achievements took place in the Indian securities market took place during this period, repeated misconduct in the stock market have led to an image of disarray, lack of transparency and fraud dominating the financial sector. Consequent collapses in the stock market have resulted in such a loss of confidence in the minds of investors, domestic and foreign, that that there has been low-level stagnation in our stock markets ever since the crash of March-April 2001.

2.7 In the present enquiry 'Scam' has to be considered predominantly in the context of the Stock/Capital market. Individual cases of financial fraud in themselves may not constitute a scam. But persistent and pervasive misappropriation of public funds falling under the purview of statutory regulators and involving issues of governance becomes a scam. The Committee attempted to examine whether various financial regulations are adequate to prevent scams and whether there have been adequate attempts to ensure that the regulatory authorities are continuously alert in discharging their duties, do not overlook the nature of fund flows into the capital market, and are alert in detecting manipulations and malpractices. The Committee also studied whether there is adequate coordination between the various regulatory authorities among themselves and with the government. In this context, the Committee examined the question of whether there should be a mechanism or institution to ensure the effective and timely implementation of Action Taken Reports presented to Parliament on recommendations made by Joint Committees constituted by Parliament such as the Joint Committee of 1992-93 and the present Committee.

2.8 The period of the scam, the main players involved, and its intensity have been examined by the Committee. The present scam includes the role of banks, stock exchanges, brokers, the Unit Trust of India (UTI), corporate bodies and chartered accountants. Regulatory authorities like SEBI, RBI and the Department of Company Affairs (DCA) should have been able to lay down and implement guidelines and procedures that could prevent such a scam or at least activate red alerts that could lead to early detection, investigation and action against fraud as well as the rectification of any systemic deficiencies discovered. Equally, supervisory authorities and coordinating bodies, such as the Ministry of Finance and HLCC, should have been more pro-active and vigilant in recognizing that liberalization requires strong and effective regulation and greater autonomy for regulators must go hand-in-hand with the accountability of regulators to the country through the Ministry of Finance which, in our scheme of constitutional jurisprudence, is responsible to Parliament for the financial health of the economy, including sectors regulated by statutory and other regulators. Moreover, the Ministry of Finance, the Regulators and all others concerned had the benefit of the voluminous and detailed Action Taken Reports (ATRs) submitted by Government to Parliament on the numerous recommendations of the 1993 Report of the Joint Committee on irregularities in securities and banking transactions. Concerted mutual interaction between Government and the Regulators, especially through the institutional mechanism of HLCC, could have signally contributed to effective pre-emptive and corrective action to forestall or moderate the scam by the early detection of wrong-doing.

2.9 Asked by the Committee to detail the steps he had taken to ensure the implementation of the recommendations of the 1992-93 JPC of which he had been a Member, the former Finance Minister (1998-2002), the Hon'ble Shri Yashwant Sinha, told the Committee :

"To the best of my recollection, I do not think that at any point of time I was told that any or many of the recommendations of the JPC were still to be implemented. I had imagined and one would imagine that by 1998—the JPC submitted its report in 1992 and there were governments in between—most of the recommendations would have been entirely implemented and exhausted. That they would remain outstanding even in 1998 was something difficult to imagine."

2.10 The main regulator of Stock Exchanges, SEBI, has been in place since 1988 and has been working under an Act of Parliament since 1992 and should have been able to regulate the liberalized market more efficiently. The Committee found that SEBI has still a long way to go before becoming a mature and effective regulator. If SEBI had continued to improve its procedures, vigilance, enforcement and control mechanisms, it could have been more effective in a situation where the stock market became unusually volatile, leading to an unprecedented surge and subsequent depression in the capital markets. It was also clear that the capital market in India is neither deep nor wide enough to moderate volatility and, therefore, a few players could attempt to manipulate the stock markets. Clearly, the various regulatory authorities were not able to foresee the situation leading to the scam and prevent it. "Nor was adequate attention paid in government circles particularly the Ministry of Finance as the custodian of the financial health of the economy."

2.11 Wrong doing by banks have also contributed significantly towards the scam although the number of banks involved in committing irregularities in comparison to the total number of banks functioning in our country is small. Notably, major banks were nationalized in 1969 but pursuant to economic liberalization, new private banks including foreign banks were allowed into banking sector. Public sector banks were in general not involved in the scam and have fared well but private sector banks need to be closely watched, especially in the area of risk management and stricter regulation. Cooperative banks have tended to ignore rules, procedures and risk management. This should set the RBI and the Government thinking. There is need to have more effective regulation in the banking sector as a whole with particular emphasis on cooperative banks.

2.12 One of the major concerns of the Committee was to look at the trading practices and procedures adopted in the stock market. Stock Exchanges, brokers and regulators play a very important role in determining the transparency of procedures and practices in the stock markets. The Committee went into the functioning of these entities and generally found that the quality of governance and the practices followed in the stock exchanges were different from exchange to exchange, having evolved from different local economic, social and historical conditions. SEBI, as a regulator, had made some attempts at standardizing the practices in these exchanges and had also instituted arrangements whereby the happening in the stock exchanges would come to its notice. But, in practice, the system did not function efficiently or in a transparent manner. When stock markets were rising, there was general lack of concern to see that such a rise should be in consonance with the integrity of the market and not the consequence of manipulation or other malpractice. On the other hand, when the markets went into a steep fall, there was concern all over. Such dissonance in the approach to issues of regulation and good governance needs to be replaced with effective regulation which concentrates on market integrity and investor protection whether at any given point of time the market is buoyant or not. This

Committee did not concern itself with either the rise or fall of the market but specifically with manipulations or irregularities that caused unusual rise and fall.

2.13 The procedures, adherence to rules and the concern for common investor appear to have been quite loose in the CSE. The payment problem that surfaced in Calcutta Stock Exchange brought to light many ills of the institution. Worse, those ills such as unofficial badla could have been recognised and corrected well in time.

2.14 The Committee discussed the period in which the present Scam surfaced, resulting ultimately in the crash of the stock market in March 2001 onwards. During the year 1999 and early 2000, the market, particularly ICE stocks, rose sharply. Thereafter, from June 2000 onwards it showed a decline which was gradual but consistent. From March 2001 onwards the decline in the SENSEX was sharp and could be termed a crash. There are a number of factors that contributed to this crash, one of which is over-reaching by one particular broker and his inability to sustain his position. In addition, during the month of January-February 2001 the Committee have found indications of large funds being withdrawn from the stock market. Whether withdrawal of large sums from the stock market was responsible for the crash or the large players withdrew the money because they knew that the SENSEX was likely to take a beating was another aspect the Committee deliberated upon.

2.15 The Committee note that Ketan Parekh who emerged as a key player in this scam received large sums of money from the banks as well as from the Corporate bodies during the period when SENSEX was falling rapidly. This led the Committee to believe that there was a nexus between Ketan Parekh, banks and the corporate houses. The Committee recommend that this nexus be further investigated by SEBI or Deptt. of Company Affairs expeditiously.

2.16 The process of liberalization of the economy has continued apace and it is market forces that will increasingly determine economic trends in the country. With liberalization, the role of the Government as a direct player in the financial market will diminish. This makes it all the more necessary that the procedures and guidelines laid down for the creation and perpetuation of fair and transparent financial markets and institutions like stock exchanges and banks have to be more specific, and effective mechanisms have to be put in place to ensure that they are regularly followed. That job will have to be done by the regulatory authorities; viz., SEBI, RBI and DCA in liaison with investigative agencies like the Income Tax Department, Enforcement Directorate and the Central Bureau of Investigation. Coordination with Government on policy issues will, however, continue to be central to good governance as there can be no escaping Government's responsibility to Parliament and the country. Therefore, Government must recognize that transactions in the market will be insulated from scams only if the relinquishment of Government control over the economy is accompanied by strong and effective regulatory bodies. This point had also been underlined by the earlier JPC Report, 1993 on Irregularities in Securities and Banking Transactions.

2.17 The proceedings before the Committee themselves acted as a catalyst for many reforms in the system, which were put in place during the Committee's pendency. These actions by regulators like SEBI and RBI and by the Ministry of Finance have been touched upon in various chapters. The Committee feel that after the presentation to Parliament in August and December 1994 of the Action Taken Reports (ATRs) on the scam relating to irregularities in securities and banking transactions, the will to implement various suggestions of the previous Committee petered out. But, as soon as this Committee began its sittings and searching questions were asked, SEBI,

**RBI and other regulatory authorities including Ministry of Finance, went into active mode. Had this state of affairs prevailed after the Action Taken Report, the probability of the present Scam would have been negligible.**

2.18 The Committee did not have the benefit of a report on the lines of the Janakiraman Committee Report which was made available to the previous JPC on the scam in securities and banking transactions. Reliable evidence was difficult to find and took much time to cull. The Committee had to rely on a number of reports that dealt with specific and limited subjects. The enquiry reports of the regulators also displayed many gaps which had to be filled by securing answers to a very large number of questions asked by the Committee. The Committee also invited comments and suggestions from institutions and the public, the contents of which have been taken into account in writing this report. The Committee thanks all concerned for the assistance they have extended.

2.19 The Special Cell constituted by the Ministry of Finance in June, 1994 to investigate the nexus between brokers and industrial houses in pursuance of the recommendation of the earlier JPC having gone defunct since May 22, 1995, without coming out with any tangible findings or recommendations for remedial action, is one of the examples of apathy on the part of different agencies and departments concerned. The Committee were informed by the Central Board of Direct Taxes that on May 19, 1995 the DGIT (Investigation), Bombay, who headed the Special Cell, had sought from CBDT adequate empowerment and administrative support for the Cell in the absence of which the Cell was unlikely to reach to any firm conclusions about the role of any one or more industrial houses in comprehensive manner but the Chairman, CBDT, in his response thereto had suggested that due to limited scope of task of the Special Cell no additional manpower was required. Also in the minutes of the last meeting of the Special Cell held on May 22, 1995, the members recorded that principal obstacle in unearthing the exact role of the industrial houses in the scam was due to the scope of the Cell was limited only to Bombay region due to which investigation into the activities of the suspects outside Bombay was not within the jurisdictional authority. Thus, the Special Cell was virtually rendered a still-born baby. The lack of concern of Government demonstrated in this casual approach to such an important issue is regrettable.

**2.20 This Scam is basically the manipulation of the capital market to benefit market operators, brokers, corporate entities and their promoters and managements. Certain banks, notably private and co-operative banks, stock exchanges, overseas corporate bodies and financial institutions were willing facilitators in this exercise. The scam lies not in the rise and fall of prices in the stock market, but in large scale manipulations like the diversion of funds, fraudulent use of banks funds, use of public funds by institutions like the Unit Trust of India (UTI), violation of risk norms on the stock exchanges and banks, and use of funds coming through overseas corporate bodies to transfer stock holdings and stock market profits out of the country. These activities went largely unnoticed. While the stock market was rising, there was inadequate attempt to ensure that this was not due to manipulations and malpractices. In contrast, during the precipitous fall in March 2001 the regulators showed greater concern. Another aspect of concern has been the emergence of a practice of non-accountability in our financial system. The effectiveness of regulations and their implementation, the role of the regulatory bodies and the continuing decline in the banking systems have been critically examined, for which the regulators, financial institutions, banks, Registrars of Co-operative Societies, perhaps corporate entities and their promoters and managements, brokers, auditors and stock exchanges are responsible in varying degrees. The parameters of governmental responsibility have also been taken into account.**

2.21 It is the considered view of the Committee that besides the factors detailed in the previous paragraph, the lack of progress in implementing the recommendations of the last Joint Parliamentary Committee set up in 1992 to enquire into Irregularities in Securities and Banking Transactions emboldened wrong-doers and unscrupulous elements to indulge in financial misconduct. The Special Cell constituted by the Ministry of Finance in June 1994 to investigate the nexus between brokers and industrial houses in pursuance of the recommendation of the previous Committee having gone defunct since 22 May 1995, without coming out with any tangible findings or recommendations for remedial action, is one of the examples of apathy on the part of different agencies and departments concerned. The Committee express their concern at the way the supervisory authorities have been performing their role and the regulators have been exercising their regulatory responsibilities. That the regulatory bodies failed in exercising prudent supervision on the activities of the stock market and banking transactions, became evident during the course of evidence taken by the Committee and this has been detailed in the succeeding chapters. In the Committee's view no financial system can work efficiently even if innumerable regulations are put in place, unless there is a system of accountability, cohesion and close cooperation in the working of different agencies of the government and the regulators.

2.22 In August 2001, after the freeze by UTI in US-64 unit repurchases, the Committee were additionally mandated by Parliament to enquire into UTI matters. The Committee find that weaknesses in management and regulations of stock exchanges was compounded by serious management deficiencies in the UTI and financial institutions. The Committee also examined the interaction between the Ministry of Finance and UTI in the context of the responsibilities of government arising out of the UTI Act of 1963 in particular of US-64 involving the investments of several million unit holders. These issues are dealt with in detail in Part II of this Report.

## CHAPTER III

### IMPLEMENTATION

3.1 The events that culminated in the exposure of the scam in March 2001, started approximately some eighteen months before that date. The earlier scam examined by a JPC was in 1992. The main concern of the Committee is why repeated scams are taking place and one of the reasons that is obvious to the Committee is that the implementation of the last JPC Report submitted on 21.12.1993 was not effective. The first ATR on that Report was presented to the Parliament in July, 1994 and then second ATR was presented in December, 1994. The ATR itself was quite exhaustive and a total of 273 recommendations were dealt with in the first ATR and 147 in the second ATR.

3.2 This Committee took a deliberate decision to examine the action on the recommendation contained in the previous JPC. As reported by the Ministry of Finance during evidence, CBI had registered 72 cases, departmental action has been completed against 52\* officials out of 285 identified as guilty by banks and Fls. Properties of 52 persons have been attached by the Custodian amounting to Rs. 3,106 crore. A special cell was constituted in 1994. Detailed guidelines were given by the Reserve Bank of India on the exposure of the banks to capital market. The Narasimhan Committee had suggested certain measures to be taken by RBI and the Department of Banking.

3.3 The Committee scrutinised the implementation of Action Taken Reports on the recommendations of the previous JPC 1992 as was incumbent on Ministry of the Finance.

**3.4 The overall impression that the JPC gathered was that after a certain time there was slackness in the implementation of the ATRs. Consequently, the Committee's general impression is that parliamentary committees carry out their work and make their recommendations but, at the implementation stage, things are put under the carpet. This impression prevails in the financial world but more so in the mind of the public in general. There being no fear that swift and effective action will be forthcoming, the players in the financial world ignore the laid down rules, regulations and procedures without any fear of punishment.**

3.5 The Committee viewed the implementation aspect under three major heads :

- (a) Progress on major issues needing action as recommended by the JPC and reflected in the ATRs subsequent to the unearthing in 1992 of the scam in securities and banking irregularities.
- (b) Whether the Ministry of Finance and various regulators had put regulatory mechanisms in place effectively, were alert enough to recognize activities in stock market detrimental to their smooth and transparent functioning in time and had taken timely action to prevent financial misconduct.
- (c) Whether the stock exchanges, banks and financial institutions themselves exercised due prudence and diligence in their respective spheres.

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\*At the time of factual verification, Ministry of Finance informed that the figure is 256.

3.6 Specific issues where the implementation was found inadequate are contained in subsequent paragraphs.

#### 1. INORDINATE DELAY IN PUNISHMENT OF GUILTY

3.7 In its revised ATR the Government stated as follows :

“Government agrees with the observations of the Committee that the system is as much in need of rectification as culpable individuals are in need of punishment. Government is fully committed to punish the guilty. Government has acted speedily to achieve this. A Special Court Ordinance was promulgated in June 1992 and later converted into an Act to ensure speedy trial of scam related cases and to permit attachment of property of identified persons and including all those whose names figures in various investigations. All identified scam related cases have been handed over to CBI, which has registered 48 cases involving 96 accused persons both from inside and outside the banking system. 76 persons have been chargesheeted and/or dealt with departmentally. CBI have already completed investigation in 47 of the 48 cases and in respect of remaining 1 case also the investigation would be completed by the end of this year...”

3.8 In the presentation given by the Banking Division, Ministry of Finance regarding further developments about the action taken in the court cases relating to the previous scam, it has been stated that :

“CBI has registered 72 cases. Chargesheets have been filed in 47 case out of which 6 cases were disposed of by Courts and the rest are pending trial. In the remaining 25 cases either departmental action was recommended or the cases were disposed of otherwise.”

3.9 Out of the 6 cases disposed of by the courts three have resulted in conviction and three cases have been resulted in acquittal. On being asked why 46 out of the 72 cases registered have still not been decided after a gap of eight years of the presentation of the JPC Report to Parliament, the witness from the CBI stated :

“As far as CBI is concerned, we have, of course been trying to expedite the cases. We have got special counsel in all these scam cases. We have written to the Ministry of Finance and Ministry of Finance has sanctioned two additional posts. However, these additional posts could not be in position because the Bombay High Court could not have spare judge for that. We have requested the Finance Ministry to write to the Chief Justice of India. He did write a letter and I have got copies of all these documents, which have been sent by the Hon’ble Finance Minister to the Chief Justice. However, because of various other factors which are not under our control we are not able to help.”

3.10 It has also been stated by CBI that the number of courts conducting trial of these cases shall have a direct bearing on the pace of disposal of these cases. The CBI have further stated that no time limit can be estimated for the final disposal of these cases and that in case the number of courts is not increased from the present level the disposal of these cases would take a long time. In cases where prosecutions against certain persons are being pursued by the CBI, the investigative process is dilatory and time consuming. The consequence is that the persons accused continues to enjoy the fruits of their fraudulent manipulations with impunity. **Unless the regulators are alert and the punishment is swift and adequately deterrent, scamsters will continue to indulge in financial misconduct. Under the present system, there is no deterrence to malpractices, irregularities and manipulations in capital markets.**

3.11 Lack of urgency on the part of the Government has led to a stage where after more than 9 years, 66 out of 72 cases of 1992 scam have yet to be adjudicated. This clearly sends out a signal that future wrong doers can evade the consequences of their wrongs and can also enjoy their ill-gotten gains. The Committee emphasise that adequate number of courts should be set up to ensure final disposal of cases within two years.

## 2. SPECIAL CELL

3.12 In pursuance of the recommendations of the previous JPC, the Central Board of Direct Taxes constituted a Special Cell on 20.5.1994 headed by the Director General of Income Tax, Mumbai and comprising representatives from CBI, RBI, Department of Company Affairs, SEBI, IT Department, etc. The Cell was to examine the role of Industrial Houses, with regard to the securities scam. The Chairman, SEBI, however, wrote that no useful purpose would be served by nominating any officer from SEBI in the proposed Cell. The Cell held 5 meetings between January, 1994 and May, 1995. On 19.5.1995, the DGIT, Mumbai wrote to CBDT for adequate man-power and administrative support for the Cell. The CBDT, however, clarified that due to the limited scope of task of the Special Cell, additional man-power was not required. After the reply of the DGIT no meetings of the Cell took place for the next six years.

3.13 After the matter regarding this Special Cell was taken up by this JPC, the DGIT, Mumbai was advised to re-convene meetings of the Cell to exchange information collected and findings arrived at by various agencies regarding the issue of nexus. The DGIT has also been asked that the Cell may also set a definite time frame for the completion of its work on the issue of nexus. The Special Cell has since finalized its report and the conclusions and findings about nexus which have prima facie emerged are as follows:—

- (a) Between Brokers and Banks/Financial Institutions—prominently visible more with Foreign Banks through various Instruments, Modes and Methods for Funds Deployment and Returns thereon.
- (b) Between Industrial/Business Houses and the Banks— mainly through the Portfolio Management Scheme, Violation of RBI Guidelines e.g.: Assured Returns etc.
- (c) Regarding the Issue whether there was any Direct Nexus of Collusive nature between the Business Houses and the Brokers. No such Direct Nexus of Collusive Nature is found to be existing at the relevant point of time. No Cases were found where Funds were placed by Industrial Houses directly with the Brokers enabling them to play in the Share/Securities Market with a view to create artificial Booms or Depressions so as to Book abnormal Profits to the detriment of the common Investors.

3.14 The Committee regret to note that the Special Cell constituted by CBDT on the recommendation of the previous JPC in order to examine the role of Industrial Houses with regard to the Securities Scam 1992 became non-functional without arriving at any findings after holding 5 meetings in 1994 and 1995. The Special Cell was reactivated after the present JPC commenced functioning. The Cell has now arrived at the finding that nexus between brokers and banks/financial institutions was prominently visible more with Foreign Banks through various Instruments. The nexus between Industrial/Business Houses and the Banks was mainly through the Portfolio Management Scheme in violation of RBI guidelines, etc. The Committee hope that in the light of these findings necessary action will be taken.

### 3. ACTION AGAINST AUDITORS

3.15 Effective audit is central to keeping any accounting manipulation or irregularity in check. In this respect auditors form the backbone of transparent and authentic financial system. In its revised ATR on the role of auditors, the Government had stated as follows :

“The Government shares the Committee’s concern regarding the weaknesses in the performance of statutory auditors of banks, PSU’s, Companies, etc.”

3.16 The Institute of Chartered Accountants of India have informed that the conduct of disciplinary proceedings against the auditors is a time consuming process. RBI have, however, requested the Institute to have a definite time frame for completion of disciplinary proceedings against the auditors.

3.17 In its report on further developments, it has been stated by the RBI that of the 27 audit firms against whom disciplinary proceedings were initiated, 4 audit firms have been exonerated by the Institute of Chartered Accountants of India (ICAI) and disciplinary proceedings in respect of 23 audit firms cases are pending at different stages. It was also informed by the RBI that considering the fact that these firms had been denied audit assignments for a number of years since 1992-93, a decision was taken in consultation with the Government of India to consider the names of these firms as statutory auditors of private sector and foreign banks from the year 1998-99. Three of these firms whose cases have not yet been decided by the ICAI namely, M/s Price Waterhouse, Mumbai, M/s Lovelock & Lewis, Mumbai and M/s S.B. Billimoria & Co have been approved for statutory audit of various private sector and foreign banks.

**3.18 The Department of Company Affairs exercises supervision over the affairs of Institute of Chartered Accountants of India and 6 members nominated by the Central Government are on the Council which manages the affairs of the Institute. The delay in adjudicating 23 out of 27 disciplinary proceedings and the approval of the names of 3 firms to conduct audit of banks even though the disciplinary proceedings are pending in their case shows complete lack of urgency and disregard of the promises on the JPC’s recommendations by the Institute of Chartered Accountants of India (ICAI), the government as well as the RBI. This Committee have also come across failures on the part of certain auditors in the present scam. Auditors have a greater responsibility and if they themselves become a part of malaise, the financial checks and balances would collapse. Department of Company Affairs should ensure expeditious disposal of disciplinary proceedings.**

### 4. INSPECTION BY RBI

3.19 Government agreed with the Report of JPC 1992 that lacunae pointed out need to be corrected and RBI also reported that they have institutionalized the system within the banks to eliminate malpractices. Despite these measures, irregularities and malpractices were noticed particularly in the working of some private banks and cooperative banks. Impact of the measures taken by RBI was however, noticeable in the conduct of the banks in the public sector largely. **It is obvious to the Committee that implementation was far from satisfactory.**

3.20 As an illustration, in the case of the Madhavapura Mercantile Coop. Bank Ltd., Ahmedabad (MMCB), the RBI inspection was carried out with reference to its financial position on 31st March, 1999. The inspection noted that the Bank had not constituted an Audit Committee and the Bank was asked to constitute one. This shortcoming was again highlighted to Chairman, CEO and a few directors in a discussion of the inspection findings of June 23, 2000. The Audit Committee was however not constituted and irregularities in the Banks operations went undetected leading to its collapse in March 2001. Audit Committee were also not constituted in the City Cooperative Bank Ltd., Lucknow. Certain irregularities had come to the notice of

Reserve Bank of India in the case of MMCB in 1998 regarding pre-sanction and post sanction follow up in respect of advances of borrowers related to the Chairman and his group companies. The matter was forwarded to the Registrar Societies, Gujarat who gave the Chairman a clean chit *vide* letter dated 2.10.99.

3.21 It has also been stated by the National Federation of Urban Cooperative Banks and Credit Societies in a submission to the current JPC that the RBI has a full fledged regional office at Ahmedabad, headed by a Regional Director to oversee and control the operations of the urban co-operative banks in the State of Gujarat and that it was incumbent on this office to investigate the abnormally high fund transfers in the last one year prior to the scam. **Dual control (that of RBI and the Registrar of Cooperative society of the State) is a matter of serious concern. RBI should have followed it up with financial penalty or such like punishment.**

3.22 These instances of regulatory laxity in the present scam are a result of delay by the RBI in following up its own inspection and observations on the functioning of banks' operations. It was also noticed by the Committee that RBI seemed content with the routine replies of the banks concerned. There appears to have been a lack of concern and absence of strict action till matters went out of hand.

## 5. REGULATION OF STOCK EXCHANGES BY SEBI

3.23 In its reply in the revised ATR, the Government stated that SEBI was empowered to nominate three persons of its choice on the Governing Bodies of Stock Exchanges. Such a system was to strengthen the regulatory system of SEBI and also enable SEBI to exercise greater supervision on the affairs of governing bodies of every recognized stock exchange.

3.24 It has been observed by this JPC that there was a very low level of attendance of SEBI nominated Directors (including nominated Directors who were employees of SEBI) in the board meetings of Calcutta Stock Exchange (where a pay in default occurred in March 2001 primarily due to lack of proper margin collection). One Director did not attend even a single meeting out of 26; another attended 3 out of 13 and yet another 25 out of 62.

3.25 The purpose of having independent nominated Directors mentioned in the ATR was, therefore, lost as the elected broker Directors attended all Board meetings and in effect took all the decisions. Thus, the implementation in respect of close supervision of the working of the Stock Exchanges by SEBI was in fact not effective.

## 6. MARGIN MONEY PAYMENT AND OTHER IRREGUAR PRACTICES IN STOCK EXCHANGES

3.26 Some of the irregular practices noticed in the stock market relate to non-payment of margin money, violations of carry forward limits, violations of trading restrictions, over-trading by Members, kerb trading, reluctance to make public data on the prices and volume of trading in a more open manner, inside trading, ineffective and at times merely notional inspection of books or brokers, insufficient and ineffective income tax surveillance of stock exchange operations and virtually no punitive action on the detection of irregularities; inefficient or non-redressal of grievances etc.

3.27 Default, which occurred at the Calcutta Stock Exchange (CSE), was primarily because the correct margins were not computed nor collected in the case of defaulting brokers and that their trading terminals were not deactivated on time. It was stated by a witness (a former executive of SEBI) that a seven point enquiry report on the CSE was submitted sometime in

1993-94 and one of the recommendations was that the permanent recognition of the exchange should be withdrawn and that the exchange should be asked to function on an annual recognition basis till corrective systems were put in place. The Chairman of SEBI on being asked about the follow up in this regard, replied,

“Sir, during the inspection of the CSE in November, 1992, many of the defects of CSE were brought out. It was recommended that the Exchange should be suspended. The SEBI Board decided to order an inquiry into the affairs of the CSE in March 1994. The SEBI Board considered the enquiry report in May, 1994 and decided that a show cause notice be issued to the CSE under section 11 of the Security Contract Regulation Act. On June 20, 1994 the then Chairman of SEBI granted a hearing to the President and the Executive Directors of the CSE. Both in their reply to the show cause notice and in the hearing said that they were willing to take corrective measures. The matter was kept in abeyance for some time. In November 1994 the SEBI Board reviewed the corrective measures taken by the CSE in respect of the findings of the enquiry. The Board took note of the steps taken by the CSE and expressed satisfaction over the same. No further action was taken. I gather this information from the record.”

3.28 Asked by the Committee to detail the steps he had taken to ensure the implementation of the recommendations of the 1992-93 JPC of which he had been a Member, the former Finance Minister (1998-2002), the Hon’ble Shri Yashwant Sinha, told the Committee:

“To the best of my recollection, I do not think that at any point of time I was told that any or many of the recommendations of the JPC were still to be implemented. I had imagined and one would imagine that by 1998—the JPC submitted its report in 1992 and there were two governments in between—most of the recommendations would have been entirely implemented and exhausted. That they would remain outstanding even in 1998 was something difficult to imagine.”

3.29 Regular inspection and follow up action of Stock Exchanges was obviously not implemented properly by SEBI. The CSE and erring brokers were let off the hook as early as 1994 which resulted in the payment crisis on CSE in March 2001. Both CSE and SEBI were lax in monitoring, surveillance, investigation and implementation. SEBI’s action was totally inadequate in dealing with irregularities mentioned in paras 3.26 and 3.27. Had the action been prompt, many of the CSE’s shortcomings could have been corrected in time.

3.30 The instances of lack of implementation indicated above are illustrative. But this Committee’s main concern is that a thorough inquiry can become meaningless unless concrete steps emerge from such an inquiry, and that their recommendations, as accepted by the Government, are implemented effectively to their logical conclusion. This is borne out of our experience from the report of JPC 1992, and the two ATRs.

3.31 Accordingly, this Committee feel that fresh thinking has to go into the implementation aspect. The Committee recommend following steps to effectively implement the recommendations contained in this report :

- (a) The Government should present their ATR on this report within 6 months of the presentation of the report.
- (b) The High Level Co-ordination Committee (HLCC) functioning in the Ministry of Finance in addition to its existing function, should be entrusted with the task of ensuring expeditious implementation of the recommendations of the JPC. For this purpose, there should be a separate Secretariat in the Ministry of Finance to assist HLCC for its efficient and effective functioning.

- (c) Every six months, the government should present to Parliament a report of progress on ATRs on the recommendations of JPCs until action on all the recommendations has been fully implemented to the satisfaction of Parliament.

3.32 The Committee are concerned to learn that the Ministry of Finance took so casual an approach to the implementation of JPC, 1992 recommendations, as set out in the two ATRs of 1994, that they neither monitored implementation nor informed successive Finance Ministers about non-implementation. This culture must change.

3.33 At Appendix-III is given a chart which sets out how many recommendations contained in this Report are analogous to the recommendations of the earlier JPC, starkly revealing the extent of non-implementation which characterises the system.

## CHAPTER IV

### IRREGULARITIES BY BROKERS INCLUDING SHCIL

4.1 Stock brokers' services form an integral part of Stock Market operations. As on 31.3.2001, there were 9,782 brokers registered with SEBI out of whom 3,763 brokers were corporate brokers. The services of Sub-brokers provide the link between investors and brokers. A number of Financial Institutions (FIs) have also been registered as brokers. There were 20 FIs registered as brokers as on 31.3.2001. Brokers and Sub-brokers are governed by SEBI regulations. However, the Committee were informed that FIs as such are not regulated by SEBI; it is only in their capacity as brokers that SEBI regulations cover FIs. A code of conduct has been prescribed in the regulations and disciplinary actions may be taken against brokers/sub-brokers violating any SEBI regulations.

4.2 SEBI has stated that it undertook investigations in the context of what it perceived as unusually volatile market behaviour around the end of February and the beginning of March 2001. According to SEBI the sharp fall in the sensex on 23.2.2001, 2.3.2001 and 13.3.2001, was on account of unwinding of long positions, short sales, delivery based sales including those of institutions and market sentiments. In SEBI's view some transactions carried out by certain entities were indicative of market manipulation.

4.3 The Committee desired to know on what basis broking entities/groups were identified for investigation. SEBI stated in its reply that as it felt that there was excessive volatility coupled with wide intra-day fluctuations in indices as well as in certain scrips immediately prior to and after the budget on 28.2.2001, there were apprehensions that certain entities were indulging in market manipulation and were artificially distorting the price discovery in the market. This perception, they said, got more pronounced in the context of what SEBI perceived as unusual market behaviour in spite of a well received Union Budget. SEBI further stated that in view of the above, the top officials of NSE and BSE were called for feedback on 2.3.2001. During discussions, the exchanges jointly identified five entities—Nirmal Bang Group, Credit Suisse First Boston (CSFB), First Global, Damani Group and Ajay Keyan Group—as the entities who, according to their information and feedback, could be indulging in such activities. Subsequently, on the basis of further feedback from the exchanges, the BL Bagri Group, CSL and Morgan Stanley were also added to the list of entities to be examined.

4.4 It is evident from the list of entities selected that the exchanges and SEBI were proceeding on the assumption of a deliberate bear-hammering to discredit a "well-received" Budget. The hypothesis on which the initial selection was made indicated that the stock exchanges and SEBI did not take into account other signals of what was going awry in the markets, including the trouble brewing in CSE, the over-extended position of the Ketan Parekh Group, the withdrawal of large investments by FIs, the non-redeployment of substantial funds by the largest ALBM operator and others, problems world-wide on stock exchanges owing to market sentiment being disillusioned with ICE stocks, and the declining trend in sensex that had set in before the presentation of the Budget. **This does not reflect well on the alertness of the Regulator to happenings in the market.**

4.5 The Committee desired SEBI to identify the top sellers in the normal segment and short sellers doing deferral of sale positions in ALBM/BLESS/MCFS in the period Oct. 2000 to March 2001.

SEBI explained in this connection that in the period Oct 2000 to March 2001, the market witnessed both upward and downward movement. Between 2.10.00 and 18.10.00 the Sensex fell by around 520 points from 4113 to 3593. Subsequently, it showed an upward trend and rose by around 700 points to 4285 on 13.12.00. It again witnessed a downward trend till 26.12.00 when it fell by around 450 points to 3827. The markets then moved up by around 600 in a rising trend till 15.2.01 when the Sensex touched 4438. In late Feb 2001 and March, there was a comparatively sharp fall of around 900 points and the Sensex fell to touch a low of 3540 on 13.3.01. SEBI stated that the market did not follow a uni-directional trend in the whole period of Oct 2000 to March 2001.

4.6 SEBI's information indicated that the top three members by net sales and the top three members by gross sales at BSE and those at NSE in this period were already under investigation. Most of the short sellers doing deferral of sale positions during this period were also under investigation by SEBI. SEBI has submitted three interim reports apart from its preliminary investigation report on the present scam.

4.7 The link between the investor and the stock market is the stock broker and sub-broker. In the March 2001 scam SEBI have found that not many stock brokers have been involved in questionable practices. The stock brokers have an important role to fill in raising equity finance from the investing public for the development of the nation. In fact, they form the distribution network for the equity markets. Majority of broker community continue to play their role in a useful manner.

4.8 SEBI's investigations covered nineteen brokers/broking groups including four brokers involved in obtaining price sensitive information in the Stock Exchange, Mumbai. This chapter covers all these entities and also the irregularities by SHCIL except the four brokers involved in price sensitive information who are covered under the Chapter on 'Stock Exchanges'.

## **1. KETAN PAREKH ENTITIES**

4.9 Investigations were undertaken by SEBI against Ketan Parekh entities in the wake of allegations that Ketan Parekh entities were involved in market manipulation in some scrips. SEBI reported in its interim reports that its investigations have revealed that 23 entities were associated/ controlled by Ketan Parekh as listed below:

- (i) *V.N. Parekh Securities Ltd.*
- (ii) *K.N.P. Securities Ltd.*
- (iii) *Triumph International Finance India Ltd.*
- (iv) *Triumph Securities Ltd.*
- (v) *Classic Shares and Stock Broking Services*
- (vi) *NH Securities*
- (vii) *Classic Credit Ltd.*
- (viii) *Classic Infin Ltd.*
- (ix) *Nakshatra Software P. Ltd.*
- (x) *Panther Fincap & Management Services*
- (xi) *Saimangal Investrade Ltd.*
- (xii) *Panther Industrial Products Ltd.*

- (xiii) Luminant Investments Pvt. Ltd.
- (xiv) Chitrakut Computers P. Ltd.
- (xv) Goldfish Computers P. Ltd.
- (xvi) Panther Investrade Ltd.
- (xvii) Moneshi Consultancy Pvt. Ltd.
- (xviii) Moncon Investment Ltd.
- (xix) Upfront Investment
- (xx) Profile Investment
- (xxi) Options Investment
- (xxii) Manmandir Estate Developers (P) Ltd.
- (xxiii) Ace Investments

4.10 A summary of SEBI's findings on the basis of its investigations is given below:-

1. Ketan Parekh was operating through a large number of entities which facilitated hiding the nexus between the source of fund flows to him from corporate houses, banks, financial institutions and foreign institutional investors and the ultimate deployment of these funds in the stock market. It was observed that funds received by certain entities from banks as loans and overdrafts were diverted to other entities for acquiring shares/meeting other obligations. It also appeared that, transactions for purchase and sale of shares were done in the name of a large number of entities so that concentration of positions/transactions in a particular scrip could not be readily detected. Thus, various layers were created so that it became difficult to link the source of fund with the actual users to which these fund were put.
2. He used a net working of various FII sub accounts, OCBs, institutions and mutual funds for large transactions thereby creating an impression of market interest in certain select scrips.
3. To begin with, he normally identified companies with relatively low floating stocks, acquired substantial holdings in these companies either directly or through associates including FII sub accounts, OCBs etc.
4. He also used the presence of a number of exchanges and different settlement cycles to systemically shift positions from one Exchange to the other Exchange.
5. While being interested in increasing or maintaining the prices of select scrips, he appears at various point of time to have systematically sold/off- loaded his holdings to book profits and take further positions therefrom to further increase the prices.
6. It was stated by Ketan Parekh that he has nothing to do with Triumph International, Moneshi Consultancy, Moncon Investment and Manmander Estate. However, SEBI is of the view that all the four companies are connected/associated with Ketan Parekh.
7. Entities associated with Ketan Parekh have received huge amounts from banks, various corporate groups etc. Some of the corporate groups which had given funds to Ketan Parekh entities during January 2000-April 2001 are Adani, HFCL, DSQ, Cadila, Essel, Koproan and Nirma and the amount outstanding from Ketan Parekh to these entities is over Rs. 1273 crore. His entities received around Rs. 80 crore from Vidyut Investments, a subsidiary of Ranbaxy. Most of the companies have claimed that the funds given

by them to Ketan Parekh entities were in the nature of Inter Corporate Deposits (ICDs) under the Companies Act. They also claim that they have given some money to buy the shares of other companies but not their own.

8. (i) Shares of DSQ Biotech, DSQ Industries were given by entities associated with promoters to Ketan Parekh entities who sold these shares through CSFB and Dresdner Kleinwort Benson (DKB) and availed of immediate funding.
- (ii) Shares of HFCL were reportedly given by promoter group entities to Ketan Parekh entities for selling to strategic investors.
9. (i) Against the sanctioned limit of Rs. 205 crore, there is an outstanding balance of Rs. 888.25 crore against the Ketan Parekh Group towards Madhavpura Mercantile Co-operative Bank (MMCB). As, against a limit of Rs. 92 crore, an amount of Rs. 225.63 crore is outstanding to MNCB from the Mukesh Babu Group. Shri Mukesh Babu has stated under oath that Rs. 57 crores was used for entities connected with Ketan Parekh and Rs. 115 crores has been utilized for transactions made for Madhur Shares which is controlled by a son of Mr. Ramesh Parekh, Chairman of MNCB. There are close knit relations between Ketan Parekh and Madhur Shares. Large funds have flowed from the Ketan Parekh account to the Madhur Shares account. It is suspected that dealings for Madhur Shares as well as through Manniar are for Ketan Parekh entities mainly.
- (ii) The amount outstanding to Global Trust Bank from Ketan Parekh entities as on 23.03.01 was Rs. 266.87 crore. The Ketan Parekh Group had also received funds from Centurion Bank, ICICI Bank and Bank of Punjab against which a total amount of Rs. 65.47 crore was outstanding.
10. MNCB issued Pay Orders (POs) in favour of Ketan Parekh entities from time to time even when there were no sufficient credits/securities to cover these loans/over drafts. Ketan Parekh entities would then discount these POs with Bank of India (BOI). The Stock Exchange Branch of BOI would present these Pay orders for realisation to the clearing house in the normal course of their business. On 8.2.2000 and 9.3.2001, MNCB issued Pay Orders totaling Rs. 137 crore in favour of Ketan Parekh entities, which were immediately discounted with BOI and the proceeds received were utilized by Ketan Parekh entities. But on this occasion when BOI presented these Pay Orders to the clearing house for realisation, MNCB declared its inability to pay, since sufficient funds were not available with the bank. Hence, BOI was left with a debit balance of Rs. 137 crore against the three Ketan Parekh entities concerned—Classic Credit Ltd. Panther Fincap and Panther Investrade Ltd.
11. Triumph Group did not provide delivery to its OCB clients on several occasions. European Investments Ltd. (EIL) had lodged a complaint with SEBI, National Stock Exchange (NSE) & RBI against Triumph International Finance India Ltd. (TIFIL) regarding dishonouring of three cheques issued to EIL by TIFIL totaling Rs. 70.71 crore toward sale proceeds. On many occasions Triumph Group did not make payment to its OCB clients for sale transactions made by them. The amount of non-payment by TIFIL to four OCBs viz. Brentfield, Kensington, Wakefield and Dossier for sales effected from December 2000 to March 2001 stood at Rs. 105.95 crore. The amount of non-payment from Triumph Securities Ltd. to Wakefield was Rs. 16.7 crore.

12. *The funds received from corporate houses and banks appear to have been used by Ketan Parekh entities for building up positions in select scrips, payment of margins, losses, pay-in obligations, taking deliveries, etc. The available information clearly indicates that the funds received from various corporate houses were mainly utilized in capital market operations. The funds have gone from Ketan Parekh entities to brokers at Calcutta and Mumbai, the three major broker Groups being the Sanjay Khemani Group, the D.K. Singhanian Group and the A.K. Poddar Group. The bulk of funds have been used by Singhanian Group and Poddar Group for taking deliveries on behalf of the Ketan Parekh entities.*

4.11 In his written statement submitted to the Committee, Shri Ketan Parekh highlighted that the restriction on the gross exposure and overall carry forward ceiling were applicable only for brokers and that he "in his individual capacity is not registered as an individual stock broker". His broking entities were corporate entities and he was only a share holder. During his oral evidence before the Committee, he was asked to clarify whether he meant that being a corporate broker he could circumvent SEBI guidelines. The witness replied that "It is legally allowed to hold shareholding in a corporate broking entity and to hold share holding in an investment company". To a query whether he as a broker or as a corporate entity, violated any of the SEBI guidelines, the witness replied in the negative.

4.12 During oral evidence, Shri Ketan Parekh admitted that he had crossed the principles of risk management and said :

"During the year 1999-2000, the companies alleged to be connected or associated with me reported profit of Rs. 215 crore and paid income tax of about Rs. 100 crore. My confidence levels in myself escalated and I started building up huge positions in the market, which required me to make large financial commitments. In the hope that my bullishness for India and Indian technology companies will come true, I crossed the principles of risk management and failed miserably. During 2000-01, the technology stocks started losing flavour with fears of recession setting in and not only NASDAQ, which is the forefront indicator of investor interest in technology but all markets across the globe went into a 'bear' phase. In India, given that I was a large investor and had grossly over-committed myself to the market, many market players started taking advantage of the situation.....In order to honour my commitments, I raised resources from bank by pledging assets, from corporates by selling my investments and from market intermediaries, etc., which instead of reducing my financial burden, actually deepened the crisis."

4.13 Asked whether his so over-stretching was justified, the witness replied in the negative.

4.14 The Committee pointed out that circular trading by Ketan Parekh entities in NSE normal segment on 9/8/2000 in the shares of Adani Exports constituted 96% of the total trade of that Exchange, namely, 1,05,000 shares out of 1,09,206 shares and on 21.11.2000, circular trading in BSE normal segment in the shares of Adani Exports, constituted 99% of the total trade and enquired whether these trades were pre-arranged and synchronized. In reply, Shri Ketan Parekh conceded that "Those trades are by our entities." He however stated that the term 'circular trade' has not been defined by SEBI or any other market regulator till date.

4.15 When it was pointed out that heavy buying and selling of shares with a view to artificially jacking up the price of a particular scrip amounts to manipulation, the witness stated :

"We were selling from our entities to CSFB in spot delivery on the day of sale. By transferring all stocks to CSFB we were receiving money on the same day. They would put the transaction in the normal system, which allowed us fifteen days or ten days period depending on the settlement cycle to pay back to buy the same stock from the market. It was absolutely a financing arrangement which was done over CSFB and it was not to induce anyone to buy that stock or to create volumes in the market."

4.16 Regarding his dealings with Dresdner Kleinwort Benson (DKB), Ketan Parekh also stated that "we used to sell stocks in spot to them and get the payment on the same day and they would sell the same stock in the market for which we had to do the payment after 10 to 15 days. So, we had that intermediary funding".

4.17 To a query whether such a high volume of transactions would not send the wrong signals to small investors to induce them to invest in the scrip, the witness said, 'Equity investment is all about perception in the future of the companies based on the history of the company.'

4.18 The Committee pointed out from the information made available by SEBI that there were numerous transactions in which the purchase and sale transactions were effected instantaneously and enquired whether these were pre-arranged. In reply the witness stated that "the only transaction of this kind will be the kind of transaction done for availability of finance." The witness also admitted that those transactions were pre-arranged. To a query as to why he was doing this trade if he had no money, the witness said,

"Sir, we had stocks within that money. We thought that the markets would go up and at some point of time, trends would reverse, and we would be able to meet our commitments out of the positions that we were holding. But the markets went down. We had to meet our obligations, and for that, we had to enter these transactions."

4.19 Asked about the amount of money he arranged by this method, the witness stated:

"What exactly happens over here is when we sell something, we get 10 days period to buy back the security. So, I have also to arrange for money to buy back securities. It is a vicious circle and I fell into that trap."

4.20 The Committee enquired whether he and his associated entities built large concentrated position in some select scrips like HFCL, Zee Tele, DSQ Software, Global Tele, etc. and whether these companies provided him large funds to jack up their prices. In reply, the witness conceded that they had large investments in these companies and said 'We did build huge positions in the market in these companies, and probably because of that I suffered that losses that I suffered.' He further said that , 'none of the corporates has ever given us money to invest in their own shares or to buy their own shares. The moneys received from the corporates were for specific contracts - for purchase of shares in the companies that they were interested in, either which we were holding or to buy them from the market. Parts of the contracts were completed in time, part of the contracts are still pending because I got into problems. The moneys that have come from these corporates have come when the markets have, in fact, started going down drastically and when the valuations thought by them were right for investing in the companies they wanted. In the whole rise of 1999-2000, not a single corporate has ever given us any money to invest in the shares. Even during the down side also, there was no money from any corporate given to us to buy their own shares or for jacking up the price.'

4.21 Referring to SEBI reports, the Committee pointed out that funds were available to Shri Parekh from HFCL Group, Zee group, Madhavpura Bank and OCBs, the witness said that 'all these monies have come in from the period of September, 2000 to March 2001' after the fall started.

4.22 According to Shri Ketan Parekh, the biggest rise in the market was during the period 1999-2000 and that his borrowings during that period was in the region of Rs. 50 crore to 100 crore. On the other hand the money borrowed by him or his entities when the market started falling was around Rs. 1500 crore.

4.23 Shri Ketan Parekh denied that his entities acquired shares in excess of 15% in the scrips of Affek, Infosys and GTB. He added further that "SEBI have taken many of the participants with whom we never had any relationship. SEBI has done an exercise where they have taken only the purchase side of the whole exercise to say that we have crossed the 15 per cent mark. They have disregarded the sale side of the transaction as such."

4.24 The Committee observed that there was huge non-deployment of funds by a major participant in ALBM towards the end of Feb. 2001 and enquired about its impact on the market. The witness explained in response:

"In the Indian market system we have a very peculiar system with the bulls and the bears together allow the system to carry forward the transaction. The financiers in this system where badla system is prevalent indirectly become a part of the bear group also because they finance all kinds of transactions. It is like buying on spot and selling after the interest was charged. They have an automatic sales position created in the market system which was guaranteed by the stock exchange. They automatically form a part of the seller group. They have a sales position in the market. What happened in the first or the second week of February was that the agency suddenly decided to see that the markets were falling. They thought that some investigation was required to find out as to why the markets are falling so fast. They raided six or seven of the so-called bear cartel group. What happened by that was that the financiers who normally have a sales position in the market suddenly started withdrawing the money because there was a general scare whether the money will come back or not. Then what would happen to bulls like us? Bulls were always dependent on the financiers and the short-sell position which was automatically allowing them to carry forward the position. So, bulls had two choices; either to pick up everything as deliveries for which the money was not available or to liquidate the position. We had a position in a couple of stocks. The whole market came down. The withdrawal of huge amount of funds during that period could definitely take the carry-forward rates to sky-high rates. Because it was the month of March and because it was the Budget time, no new funds were available or introduced at that point of time by anybody to allow the bulls to carry forward the position. That led to an unprecedented fall in the market."

4.25 According to Shri Ketan Parekh the whole fall in the market which happened after the Budget in 2001 was only "because the whole finances were getting withdrawn from the market." He added that the fall had started before the ALBM money was withdrawn and there was a downswing in the market. He replied in the affirmative to a query whether he was depending on ALBM financing. Asked about hammering down of prices, the witness said :

"The drastic fall in the market is always not because the bear short sells very heavily. It is also because of bull liquidation. That is why we saw vertical drop in the market."

4.26 Asked about the range of yield in badla/BLESS, the witness said it was in the range of 15-20 per cent in Feb. 2001 as compared to 12-15 percent in Oct.-December, 2000.

4.27 Taking note that the Stock Lending Scheme may have been misused in ALBM, the Committee enquired whether the Stock Lending Scheme could be misused again in the future, the witness was of the view that:

"It can be, but as I believe, almost all custodians of the shares are now very vigilant on who is borrowing, how much quantity they are willing to part with and how continuously those people come forward to ask for stocks. But public memory again is short. Two or three years down the line this can happen once again."

4.28 Shri Ketan Parekh indicated that his entities were doing a lot of arbitrage between Kolkata Exchange, BSE and NSE. They also used to have a lot of shares purchased for investment purposes. This was done through about 40 brokers such as Sanjay Khemani, Dinesh Singhania, Ashok Poddar and so on. The witness said a sum of Rs. 3191 crore has been paid to Calcutta based brokers not Rs. 2810 crore as mentioned in the SEBI report. These were towards commitment from investment trading being specifically for purchase of shares, payment of margins and meeting of losses in respect of trades carried out by our various companies. To a query whether the advantage of a faulty margin system in CSE was an inducement for his transactions in the exchange, Shri Ketan Parekh replied in the affirmative.

4.29 When asked whether the payment crisis in CSE in settlements No. 148 and 149 was due to his dealings with the CSE brokers, the witness explained:

"Sir, I would give you a clear picture as to what happened on that day when one of the brokers, namely, Shri Dinesh Kumar Singhania defaulted. He had outstanding position since about six to seven months regularly on certain stocks. On the day of the settlement they decided to pick up and deliver and they thought that they would be able to raise the funds and carry it forward on our behalf. This is an internal arrangement on which we have nothing to do. We never asked them to lift the stocks. We were carrying it forward. For the three to six months we asked them to carry it forward. On the second last day of the next badla, normally they used to arrange for funds which automatically carried forward the position. On the sixth day the market went down by 50 per cent and they could not arrange for the funds. On that day I had a receivable from those brokers. They said that they needed funds to see that they did not default at the Exchange. Late in the night, though we had a receivable of Rs. 55 crore from them, to avoid default over there, because their default would be because of my position standing over there, we had sent something like Rs. 55 crore. I did not know that even after sending that money also they would ultimately default."

4.30 Pointing out that co-operative Banks cannot invest more than 5% of their loanable fund in equities, the Committee enquired how he could borrow nearly Rs. 900 crore from MMCB, the witness said :

"I had a big security of about Rs. 450 crore in Madhavpura at that point of time."

4.31 The witness denied that he had any nexus with the then Chairman of MMCB. However, he admitted that :

"I do believe that we have definitely done lot of things like borrowing, which we should not have done...."

4.32 Referring to the Pay Order issued by MMCB, the Committee enquired whether the Bank was aware that it was issued in favour of Shri Ketan Parekh without balance in his account, the witness said, "I believe so".

4.33 When the Committee observed that he had a role in the CSE payment crisis and the crash of the Madhavpura Merchantile Cooperative Bank which have led to a huge loss for the common investor, Shri Ketan Parekh responded by saying that, at the end of the day, he was the biggest loser.

4.34 SEBI has stated that around Rs. 1500 crore was received by KP entities from various banks mainly MMCB, GTB, ICICI Bank, etc., and movement of funds around Rs. 1275 crore from corporate entities to KP entities was also noticed around Feb.-March, 2001.

4.35 Asked about the losses suffered by Ketan Parekh entities, SEBI stated in a written reply that it might be possible to hazard a guess about losses of KP entities on the basis of amount payable by them to various institutions, banks, corporates, brokers, OCBs, etc. According to SEBI, it appeared that Ketan Parekh entities suffered loss in range of Rs. 3000 crores to Rs. 4000 crore. The amount payable by KP entities is stated to be as follows :

Name of the entity	Amount (Rs. in crore) approx
Madhavpura Mercantile Co-operative Bank	888.00
HFCL	550.00
Essel Group	450.00
Adani Group	132.00
DSQ Group	75.00
Shonkh Technologies	37.00
Kopran	28.00
Global Trust Bank	267.00
ICICI Bank/Centurion/Bank of Punjab, etc.	66.00
OCBs (delivery of shares not given and sale proceeds not paid)	480.00
Amount due to various brokers**	350.00
<b>Total</b>	<b>3323</b>

\*\*Amount due to Poddar group, Rs. 59.00 crore, Singhanian group, Rs. 91 crore, Mukesh Babu Rs. 100 crore, Indsec Rs. 60 crore, Milan Mahendra Rs. 40 crore.

4.36 In addition to these amounts, shares have reportedly given to Ketan Parekh entities by DSQ Group, HFCL Group, Shonkh Technologies, etc. have neither been given back by Ketan Parekh entities nor has consideration for the same been given by Ketan Parekh entities to the transferor. According to SEBI, it appeared that Ketan Parekh entities owe around Rs. 1300 crores to these corporates for the value of shares taken from them.

4.37 SEBI has reported that on the basis of investigations, it has taken the following action against Ketan Parekh entities:—

*Enquiry proceedings have been initiated against broking entities connected/associated with Ketan Parekh for prima facie violation of SEBI Act, and its various Regulations. Earlier an order u/s 11B of SEBI Act was passed debarring these entities from undertaking any fresh business as a broker. Pursuant to investigations into Aftek Infosys, Lupin Laboratories, Global Trust Bank, Shonkh Technologies, show cause notices have been issued to various non-broking entities connected/associated with Ketan Parekh for their prima facie involvement in price manipulation under the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating into securities) Regulations, 1995 read with SEBI Act.*

*By an order dated 16.5.2002, SEBI has cancelled the registration of Triumph International Finance (India) Ltd. for indulging in market manipulation in a number of scrips and for acting in a manner detrimental to the interest of its clients.*

*Entities associated with Ketan Parekh prima-facie appeared to have violated Takeover Regulations in the scrip of Aftek Infosys, Global Trust bank and Shonkh Technologies. Appropriate actions i.e. Adjudication Proceedings and Show Cause notice for directions under regulation 44 of SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997 read with section 11 B of SEBI Act have been initiated against these entities.*

*Investigations have revealed that Ketan Parekh entities acquired shares of Shonkh in excess of 15% and / or 5% of the company entities in February 2001 without complying with the SEBI (Substantial acquisition of shares and Takeovers) Regulations, 1997 (i.e. without making disclosures to the company and without making public offer). For these violations, show cause notices have been issued to eleven Ketan Parekh entities.*

*The investment companies/NBFCs associated/connected with Ketan Parekh are not under the direct regulatory purview of SEBI. If the investigation bring out the role of any specific investment company/NBFC associated/connected with Ketan Parekh in market manipulation/insider trading/other irregularity under SEBI Act and its Regulations, appropriate actions in terms of SEBI Act and its Regulations would be initiated after following the due process of law against the respective entity in light of findings of investigations. Further investigations are being carried out on a priority basis and efforts are being made to complete the investigation expeditiously.*

4.38 SEBI has stated in a written reply that the case is being examined independently for criminal action after evaluation of the evidence and that the filing of criminal complaint is handled by independent advocates.

4.39 During his oral evidence on 3.1.2002, Shri Ketan Parekh denied that any of his family members or any of his investor companies or brokering companies had any foreign account.

4.40 The Central Bureau of Investigation is stated to have received a letter dated 26.6.2001 from the Examining Magistrate's Office-IV, Canton of Zurich/Switzerland through Interpol, India, stating that they had initiated criminal proceedings against an Indian citizen named Parekh Ketan based on suspicion of money laundering and forgery. They received information about an account at Credit Suisse in Zurich. Contracting partner of the account is a Corporation named ELISTA LIMITED, Nassau, Bahamas, whose beneficial owner is Ketan Parekh. This account has been frozen by order of the Swiss Authorities.

4.41 A Letter Rogatory seeking detailed information about the Swiss Accounts of Shri Ketan Parekh were secured from Ld. CMM. Ahmedabad on 25.09.2001 and forwarded by Interpol on 28.09.2001 to the Ministry of External Affairs for its onward transmission through diplomatic channels to the competent authorities in Switzerland. In pursuance of the execution of the Letter of Request, response from the competent authority in Switzerland is awaited. In the light of outcome thereof, further necessary investigation would be carried out in India.

**4.42 The Committee find that Shri Ketan Parekh was a key person involved in all dimensions of the stock market scam which surfaced in March 2001, as also in payments problem in the Calcutta Stock Exchange (CSE) and the crash of Madhavpura Mercantile Cooperative Bank (MMCB). He was operating through a large number of entities which facilitated hiding the nexus between source of funds flow and their ultimate use. Various layers were created in his transactions so that it became difficult to link the source of fund with the actual user of fund. SEBI's investigations after the scam have revealed that the amount outstanding from Ketan Parekh entities to certain corporate houses at the end of April, 2001 was over Rs. 1,273 crore. Dues of Ketan Parekh entities to MNCB were around Rs. 888 crore and to Global Trust Bank over Rs. 266 crore. There were also dues to other entities. The funds received from corporate houses and banks have gone to three major broker groups in CSE and been utilized in capital market**

operations. Ketan Parekh entities appear to have chosen CSE mainly to exploit the known weaknesses of the EXchange. They also used a networking of various Overseas Corporate Bodies, Foreign Institutional Investor sub-accounts and mutual funds for large transactions. Not till the MNCB crash occurred did the regulatory authorities even begin looking in Shri Ketan Parekh's directions although this was being underlined in Parliament and the media. It is difficult to believe that the Stock Exchanges or SEBI were quite unaware of what was going on in the market when Ketan Parekh entities were manipulating the market using their network. Nor did the High Level Coordination Committee (HLCC) or the SEBI seek a check on where Shri Ketan Parekh was getting his funds from or his methods of manipulating the market. This is all the more disturbing in the context of the previous JPC's findings against Shri Ketan Parekh.

4.43 During the oral evidence before the Committee, Shri Ketan Parekh owned up involvement of his entities in the CSE payment crisis and the crash of Madhavpura Mercantile Co-operative Bank in March, 2001. Shri Ketan Parekh admitted that his entities did build huge positions in the market in select scrips, that they grossly over committed themselves to the market and that they crossed the principles of risk management. Further, he also conceded that certain trades such as the sale to Credit Suisse First Boston and Dresdner Kleinwort Benson, which SEBI described as 'Circular trades', were pre-arranged trades though he claimed that those trades were meant for short term funds. While acknowledging that his entities received funds from certain corporate houses and that they built huge positions in the market in these companies, Shri Ketan Parekh asserted that his entities received those moneys only after the start of the market fall from September, 2000 and that the corporate funds were not for investment in their own shares nor for jacking up price. Notably, he disclosed that MNCB issued pay orders without balance in his account. Shri Ketan Parekh also divulged that his entities paid to Calcutta based brokers a sum of Rs.3,191 crore towards purchase of shares, payment of margin, etc. and acknowledged that they availed of the advantage of faulty margin system in Calcutta Stock Exchange. All these admissions of Shri Ketan Parekh corroborate the SEBI's findings. The committee note that SEBI has since taken action to cancel the registration of Triumph International Finance (India) Limited. The Committee urge that SEBI must complete its remaining investigation expeditiously and take swift action for various violations by Ketan Parekh entities including the criminal action which is stated to be under contemplation.

4.44 The various acts of omission and commission having been clearly established, the Committee urge that the Government should take all necessary steps to finalize proceedings against Ketan Parekh entities and to ensure that suitable action is taken against them without delay. The Committee also urge that expeditious action should be taken to ascertain the facts regarding the Swiss bank account of Shri Ketan Parekh and to follow up the matter.

4.45 Ketan Parekh entities owe considerable sum of money to Banks. Expeditious action should be taken to recover this amount from Ketan Parekh entities.

## 2. CSE DEFAULTED BROKERS

4.46 In Calcutta Stock Exchange (CSE), 10 brokers defaulted in making their pay-ins in settlement nos. 148, 149 and 150 due on 8.3.2001, 15.3.2001 and 22.3.2001 respectively. The ten brokers had a short-fall of about Rs.107 crore in pay-in obligations in these settlements. This pay-in problem at CSE revealed that large positions were built up by these brokers in few scrips and they had close linkages with Ketan Parekh. In the light of the above, SEBI undertook investigations in the developments at CSE. The discussion regarding 'CSE defaulted brokers' is also partly covered under the Section 'Calcutta Stock Exchange' in Chapter-VI of this report.

4.47 The defaulted brokers of CSE belong to three groups as shown below:-

### D.K. Singhanian Group

1. D.K. Singhanian
2. Tripoli Consultancy
3. Arihant Exim Scrip P. Ltd.
4. Doe Jones.

### A.K. Poddar Group

1. A.K. Poddar
2. Prema Poddar
3. Ratanlal Poddar
4. R.K. Poddar

### H. Biyani Group

1. Harish Biyani
2. Biyani Securities

4.48 As brought out in the previous section, Ketan Parekh entities had paid a sum of Rs. 3191 crore over a period to Dinesh Singhanian group, Ashok Poddar group and Sanjay Khemani group for purchase of shares, payment of margins, etc. in CSE.

4.49 SEBI's initial investigation of the above defaulted brokers of CSE has brought out the following:-

1. *The net amount of outstanding due to CSE on account of pay-in liabilities pertaining to the settlement nos. 148, 149 and 150 from Singhanian group is Rs. 34.43 crore; from Poddar group Rs. 26.84 crore; and from Biyani group Rs. 30.10 crore. CSE completed the payout of the above mentioned settlements by meeting the shortfall on account of the pay-in default by these brokers out of the Settlement Guarantee Fund and other reserves of the exchange.*
2. *It appears that, the three Groups had defaulted mainly due to the following reasons:*
  - *Building up of large concentrated position by three Groups in few scrips mainly in HFCL and DSQ.*
  - *Volatility in prices during the relevant period. Downward movement in the prices of HFCL and DSQ (in HFCL and DSQ the price fell by 75% and 66% respectively between 1.3.2001 and 14.3.2001).*
  - *Violation of SEBI directives dated 2.8.1999 and 16.4.2000 regarding exposure limits and margins by CSE.*
  - *In July 1999, SEBI issued circular requiring the stock exchanges, inter-alia, to include the crystallized delivery position of the previous settlement in the total exposure of the current settlement. Compliance with SEBI circular in this regard would have limited the trading by the brokers in terms of the capital deposited by the brokers vis-a-vis their exposure. This also would have meant payment of higher margins. Crystallized delivery positions pertaining to settlement no.148 which ended on 1.3.2001 amounted to Rs.150 crore in the case of Singhanian Group; Rs.28.43 crore in the case of Poddar Group and Rs.43.12 crore in the case of Biyani Group. Non-compliance of SEBI circular benefited the brokers to the above extent in the exposure of the next settlement no.149 which commenced on 2.3.2001.*
  - *CSE also did not reduce the capital available by the amount of margin due as per SEBI circular. This allowed the three Groups to have higher exposures than would have been permissible. Non-compliance of SEBI circular allowed the brokers to continue with their total exposure of Rs.424.37 crore (Singhanian Group Rs.266 crore; Poddar group Rs.75.87 crore and Biyani Group Rs.82.50 crore) even after their margin liability exceeded the total amount of capital deposited by them with the exchange.*
  - *It has been observed that in the case of Singhanian Group, margin money payable for the trading positions taken upto 2.3.2001 and 5.3.2001 should have been paid by the next trading day i.e. 5.3.2001 (3rd and 4th March were holidays) and 7.3.2001 (6th March was holiday). Singhanian Group did give cheques amounting to Rs.13.12 crore and Rs.11.61 crore towards the margins for 2.3.2001 and 5.3.2001 respectively as per the computations of CSE (though margins payable as per SEBI circular were Rs.38.52 crore and Rs.16.15 crore respectively for these two dates). These margin cheques given by Singhanian Group bounced and all these cheques were returned by the bank after a few days of delay on 10.3.2001.*

- *In case of Poddar Group margin money payable for the trading positions taken upto 5.3.2001 should have been paid by the next trading day i.e. 7.3.2001 (6th March was holiday). Poddar Group did give cheques amounting to Rs.3.84 towards the margins on 5.3.2001 as per the computations of CSE (though margins payable as per SEBI circulars were Rs.14.72). This margin cheque given by Poddar Group bounced and this cheque was returned by the bank.*
  - *Understatement of margin due to bug in computer system of CSE for computing gross exposure margin. Margin liability was understated to the extent of Rs. 29.29 crore in the case of Singhanian Group, Rs.13.41 crore in the case of Poddar Group and Rs.2.80 crore in the case of Biyani Group as on 1.3.2001.*
  - *Failure of surveillance department of CSE to detect concentration of position built by the brokers in HFCL and DSQ and to take preventive action.*
3. *Had CSE followed SEBI circulars on risk management system, CSE could have deactivated the trading terminals of D K Singhanian group atleast 8 days prior to the pay-in default on 8.3.2001. Thereby, CSE could have prevented Singhanian Group from building up a position of Rs.112.69 crore (being the positions built up by Singhanian Group after the violation of exposure limits and failure to pay margins).*

*Similarly, CSE could have deactivated the trading terminals of Poddar Group atleast 2 to 6 days prior to the pay-in default by Poddar Group for settlement No.148 which was due on 8.3.2001. Thereby, CSE could have prevented Poddar Group from building up a position of Rs.25.69 crore.*

*CSE could have deactivated the trading terminals of H C Biyani and Biyani securities on 27.2.2001 and 23.2.2001 respectively i.e. atleast 10 days prior to the pay-in default by Biyani Group for settlement No.148 which was due on 8.3.2001. Thereby, CSE could have prevented Biyani Group from building up a position of Rs.51.25 crore.*

4. *The total amount due (around Rs.91.98 crore) from KP entities is far higher than the total outstanding of Rs.34.43 crore due to CSE by Singhanian Group. The position in this regard in respect of Poddar Group was around Rs.58.5 crore due from KP entities as against Rs.26.84 crore due to CSE.*
5. *As per the declaration made by these brokers to CSE, almost all the trades executed by them were declared as self trades i.e. proprietary trades and the trading done on behalf of K P entities.promoters of DSQ Software and other defaulter brokers had not been disclosed to CSE.*
6. *As per the data provided by these brokers, the composition of business done on behalf of common investors is very negligible. It may be mentioned that interests of the common investors have not been adversely affected due to the default by these brokers as the business done on behalf of common investors by these brokers was negligible and CSE had met the entire pay-in shortfall of these brokers out of its Settlement Guarantee Fund and other general reserves of the CSE and ensured that the pay-out was made on time.*

4.50 CSE declared all the ten entities of the three Groups which defaulted in meeting the pay in obligations for the settlement Nos. 148, 149 & 150 as defaulters and initiated recovery proceedings including civil and criminal proceedings against them. Registration of stock broking entities of Singhanian Group, Poddar Group and Biyani Group has already been cancelled by SEBI under the SEBI (Stock Broker and Sub-brokers) Regulations, 1992. SEBI by its order

dated 18.10.2002 has debarred eighteen persons belonging to the groups of Singhanian, Poddar and Biyani from associating with securities market activities and dealing in the securities market till the completion of investigation. SEBI has also initiated prosecution proceedings against fourteen persons belonging to Singhanian Group, Poddar Group and Biyani Group.

4.51 Based on the investigation of the three broking groups, SEBI inspected book of accounts of top 25 brokers by volume who indulged in off-the floor transactions with these three groups and also with Khemani Group. Based on the inspection findings, enquiry has been initiated against all the 25 brokers by SEBI. Further 261 brokers of CSE, who indulged in off-the floor transactions with these groups have also been identified and SEBI has advised CSE to inspect and take appropriate action against them.

4.52 On the basis of complaint made by CSE, the Special Cell of Detective Department of Kolkata Police have arrested 13 accused persons belonging to the broker groups and their associates including former M.D. of SHCIL and Sr. Vice President of IndusInd Bank.

4.53 The Committee took oral evidence of Shri Dinesh Kumar Singhanian, Shri Ashok Kumar Poddar and Shri H. Biyani (each one separately) on 11.1.2002.

4.54 Shri D.K. Singhanian was Director of Kolkata Stock Exchange when his default occurred. Previously, he was President of the exchange for two years from 1994-96. During the evidence, Shri Singhanian attributed the default in settlement No. 148 to massive fall in the market which was more than 50 percent between 1.3.2001 and 8.3.2001 as against the normal fall of 5-10-20 percent in the market during adverse condition. Shri Singhanian said that his total liability in Settlement No. 148 was Rs. 137.78 crore and he was short by almost Rs. 50 crore. He further said that payment to CSE was made on 9.3.2001 by squaring up his transactions with 25 lakh shares of HFCL at the rate of Rs. 225 per share which was less than the prevailing rate. The Committee enquired why it was not squared up on the pay-in date viz. 8th March and whether the squaring up was intentionally deferred to 9th in order to shift the obligation of squaring up from himself to the Exchange. The Committee further enquired whether being a member of the Board he had any role in deferring the square up. In reply, the witness said that "This decision is with the Calcutta Stock Exchange Authority and if any member does not make timely payment then the Calcutta Stock Exchange takes authoritative steps in order to liquidate the position of the members. There is no role in it of the members who fail to fulfil the payment obligation." When enquired whether squaring up the next day was the usual practice and if so, how many times had it happened in the past, Shri Singhanian stated that it had perhaps happened two to four times.

4.55 Taking note that Shri D.K. Singhanian was a former President of CSE and a responsible broker, the Committee enquired whether it was not his responsibility to report to the exchange about under statement of margin by the computer system in CSE. Shri Singhanian replied that there was nothing in his knowledge that there was a bug in the margin system due to which margin was charged less. He further stated, "Our fault was that we did not use to do any calculation at our level. We did our margin payment on the basis of download which used to come from the side of Stock Exchange". When the figures regarding violation of exposure limit and outstanding positions of his group was read out to him from the SEBI report, Shri Singhanian confirmed those figures.

4.56 When his attention was drawn to SEBI's observation that all the trades executed by him were declared as "Self trades" and the trading done on behalf of KP entities had not been disclosed, the witness said, "Whatever business we used to deal in was on behalf of Shri Ketan Parekh. That was done in the name of his company only. It is not true that we used to enter any of his transactions in our account".

4.57 During the oral evidence of Shri A.K. Poddar, the Committee asked how his default took place. In reply, Shri Poddar said that there was no timely payment by his client Ketan Parekh. To a query whether he paid margin on balance or on total trading, Shri Poddar said that margin was paid "on balance". Asked about his view whether the margin should be paid on net position or gross position, he said, "According to emerging situation, it should be on gross." Regarding the question of under-statement of margin due to computer bug, Shri Poddar said, "we were not aware of that computer bug". When it was pointed out to him from SEBI report that he had violated the carry forward limit 64 times between October 2000 and March 2001, the witness responded by saying that "there was no such limit. We had never been told in Stock Exchange like this." He also denied that he had made any violation regarding crossing the margin or limit. To a query whether he used to transact any outside deal, he replied in negative.

4.58 SEBI has observed that Biyani Group has done sizeable business, mainly in DSQ on behalf of promoters of DSQ Software Ltd. The companies connected with promoters of DSQ owe substantial amounts to Biyani Group on account of trading done (mainly in DSQ Software Ltd. towards deliveries taken and trading loss).

4.59 He informed the Committee that his trading terminal was closed because of bouncing of his cheque of Rs. 9 crore. When asked how much money he owed to CSE, Shri Biyani explained, "My terminal has been closed on the 5.3.2001. I couldn't finalise those deals which were already in the process....Had Kolkatta Stock Exchange cleared my deals on time. I would have squared up. Considering my security margin and deals, I would not have been on default for a long period and I would have managed that." About his dues to CSE, he said that his dues would not have exceeded Rs. 18-19 crore but CSE had reportedly demanded Rs. 30 crore from him.

4.60 Biyani Securities Ltd. had deposited on 21.3.2001, 10 lakh equity shares of DSQ Software Ltd. bearing distinctive Nos. 43250001 to 44250000 along with a transfer deed to the Exchange as security towards their pay-in dues to the Exchange. Biyani Securities wrote to the Exchange that the shares might be transferred in the name of the Exchange and sought 90 days time to clear the dues with the request that the shares should not be sold till then. They confirmed that the Exchange could dispose them in case they failed to clear their commitment within the said period of 90 days.

4.61 Biyani Securities Ltd. had reportedly claimed in its correspondence with the Calcutta Stock Exchange that 10 lakh shares of DSQ Software Ltd. proposed to be transferred to CSE in lieu of dues were obtained from its client viz. New Vision Investment Pvt. Ltd. Subsequently, Biyani Securities reportedly claimed that it had received the shares from one Shri T.C. Ashok on personal relationship to bail it out of payment crisis. Shri T.C. Ashok is reported to have stated that he does not know Harish Biyani Securities or New Vision Investment Pvt. Ltd.

4.62 During the oral evidence Shri Biyani submitted that he deposited to CSE 10 lakh DSQ Software Shares worth Rs. 10 crore as "Interim Security". He however, emphasized that "those shares were in physical form, not to be sold". To a query whether those shares were in his name, Shri Biyani replied in the negative and said, "I did not have ownership of those shares." Enquired how then could he give those shares to CSE, he said, "Because I became a defaulter. I was in crisis". Shri Biyani mentioned that he had transfer deed of those shares with him and added that Shri T.C. Ashok provided him those shares.

4.63 To a query about the action initiated by CSE against Shri Biyani, the CSE informed in a post evidence reply that an FIR was lodged with police authorities on 2.11.2001 against Shri H.C. Biyani and M.s Biyani Securities Ltd. who had deposited those shares.

4.64 Shri H.C. Biyani has a DP beneficiary account with SHCIL. On 1.3.2001, he requested SHCIL to sell 2.4 lakh shares of DSQ Industries Ltd. under Sell-n-Cash scheme. The shares were sold on the same day by SHCIL in rolling settlement No. 2001518 of CSE through Biyani Securities Pvt. Ltd., an associate firm of Shri H.C. Biyani on whose behalf the trade was executed. SHCIL made payment against this transaction to Shri Biyani on the same day after deducting brokerage and service charges from the sale proceeds of Rs. 8.04 crore. SHCIL also executed another transaction for sale of 7.2 lakh shares of DSQ Industries under Sell-n-Cash scheme on behalf of Shri Biyani through Biyani Securities Pvt. Ltd. in settlement No 2001159 for Rs. 24.48 crore on 2.3.2001. Unlike the earlier transaction, SHCIL released the payment through a post-dated cheque to Shri Biyani who discounted the cheque with IndusInd Bank, Calcutta and received the sale proceeds.

4.65 In the transactions of sale of DSQ Industries shares dated 1.3.01 financed by SHCIL on behalf of its clients Shri H.C. Biyani under Sell-n-Cash scheme through Biyani Securities Pvt. Ltd. and CSE, the counter party broker was Shri H.C. Biyani himself. In the transaction dated 2.3.2001, assured/facilitated by SHCIL for Shri H.C. Biyani the Counter partybrokers were Shri H.C. Biyani, Arihant Exim & Doe Jones CSE, on scrutiny of pay-in/pay-out of settlement No. 148 and the rolling settlements falling due during the same time, classified the trades financed/assured by SHCIL through Biyani Securities Pvt. Ltd. as trades in the nature of accommodation and expunged these trades.

4.66 Enquired about these transaction, Shri Biyani stated during evidence that since he was in need of funds he sold DSQ shares to SHCIL and received a post dated cheque from them and got the cheque discounted. He further said that SHCIL in turn sold those shares in the market on the same day through Biyani Securities but CSE did not make payment since the deals were expunged.

4.67 As per SEBI's investigation carried out on the data provided by the Biyani Group in soft form, the Biyani Group's outstanding to CSE is mainly attributed to the shares of DSQ Software Ltd., HFCL and Global Software in the settlement Nos.148,149 & 150 in value terms. The trades in the shares of DSQ Software and HFCL were declared as "self" trades by the Biyani Group. SEBI has later observed from the data provided by the Biyani Group in soft form that most of these trades were done on behalf of the client "Hulda Properties & Trades Ltd." The trades in Global Software Ltd., was done on behalf of a client "Rathyatra Sales Pvt. Ltd."

**4.68 The Committee note that the three broking groups belonging to Shri D.K. Singhania, Shri A.K. Poddar and Shri H.C. Biyani were primarily responsible for the payment problem in March 2001 in CSE. Their default in pay-in obligations in three settlements in March 2001 was about Rs. 107 crore. D.K. Singhania Group and A.K. Poddar Group along with Sanjay Khemani Group received over a period a sum of Rs. 3191 crore from Ketan Parekh entities for taking deliveries on behalf of the latter and had close linkages with Shri Ketan Parekh. The Committee find that these broker groups exploited the weaknesses in the working of Calcutta Stock Exchange as discussed in another section of this Report and built large concentrated position in a few scrips in violation of exposure limits. The brokers' plea of ignorance about the defects in the CSE margin system is not convincing. The Committee urge that the civil and criminal proceedings**

initiated against the defaulted brokers should be expeditiously completed and the guilty punished at the earliest.

4.69 Shri H.C. Biyani had deposited 10 lakh shares of DSQ Software Ltd. as security towards his pay-in dues to CSE on 21.3.2001. It transpired during the Committee's examination that Shri Biyani did not have ownership of those shares when he deposited them and could not have transferred the shares to CSE. It was a fraud on CSE by Shri Biyani. CSE has reportedly filed an FIR against Shri Biyani and Biyani Securities in this regard. The Committee expect that the matter be investigated and on the basis of outcome thereof, appropriate criminal proceedings will be initiated.

4.70 In another instance, Shri H.C. Biyani had entered into a transaction with Stock Holding Corp. of India Ltd. (SHCIL) which was classified by CSE as trade in the nature of accommodation and expunged the same. The trade in question related to his sale of DSQ Industries shares under Sell-n-Cash scheme of SHCIL on 2.3.2001 for Rs.24.45 crore where the counterparty broker was Shri Biyani himself. This matter has since been looked into by an independent inquiry appointed by SHCIL as dicussed in the section on SHCIL.

### 3. OTHER BROKERS

4.71 SEBI's investigation in connection with the present scam covered nineteen brokers.broking groups including Shri Ketan Parekh, three CSE defaulted brokers and four brokers of Stock Exchange, Mumbai regarding obtaining price sensitive information. This section discusses the eleven brokers.groups which are not covered in other sections of this report.

#### A. First Global Group

4.72 First Global Stockbroking Pvt. Ltd. (FGSB), is a Corporate Trading Member of BSE and NSE. Shri Shankar Sharma, Smt. Devina Mehra and Virta Trade & Agencies Pvt. Ltd. (owned by Shankar Sharma and Devina Mehra) are its main promoters. Shri Shankar Sharma was also a member of the Vadodara Stock Exchange. FGSB has the following known Associate concerns:

1. *First Global Stock Broking Pvt. Ltd.*
2. *Vruddhi Confinvest India Pvt. Ltd.*
3. *First Global (UK) Ltd.*
4. *First Global (Mauritius) Ltd.*
5. *First Global SG (USA) Inc.*
6. *First Global Finance Pvt. Ltd.*
7. *UD & MD Agency Pvt. Ltd.*
8. *Shreenath Commercial and Finance Ltd.*
9. *Virta Trade and Agencies Pvt. Ltd.*
10. *Topgear Leasing and Finance Pvt. Ltd.*
11. *Garma Trexim Pvt. Ltd.*

4.73 As on 31.3.2001, FGSB had equity capital of Rs.8.0 crore with reserves and unsecured loans rising to Rs.10.50 and Rs.19.01 crore respectively. The brokerage receipts have increased to Rs.21.26 crore as on 31.3.2000. The combined turnover of FGSB at BSE & NSE in the financial year 1999-2000 and 2000-2001 is as follows:

1999-2000	Rs. 6005 crore
2000-2001	Rs.14180 crore

#### (I) SEBI'S findings

4.74 SEBI's investigation reports contained the following main findings with regard to trading by entities of the First Global group:—

##### (1) Violation of SEBI (Fraudulent and Unfair Trade Practice) Regulations, 1995

*At BSE, FGSB had substantial net sales in proportion to the exchange net position with a peak of around 18% of the exchange net position in HFCL in certain periods, which had impacted price fall in the scrip in short term and over a period of time. There were also instances of large short sales (which were carried forward in BLESS) in scrips such as Wipro, SSI and Sterlite Optical.*

*Similarly at NSE there was a trading pattern showing substantial unwinding of long positions, substantial short sale positions and large sales deferral by the member in scrips which are either part of stock indices or are significant momentum scrips. This indicated a concerted attempt to hammer their prices and impact the market as a whole.*

*Proprietary trading by the First Global Group was mainly done through sub-broker Vruddhi Confinvest. Positions held by Vruddhi at BSE constituted around 95% of the member's sales carry forward position. The proprietary carry forward sale position was as high as 83% of the total carry forward sales at the exchange. The member had substantial carry forward positions at BSE in the scrips of HFCL, Infosys, Satyam, SSI, Sterlite Optical and Wipro.*

*The member and its proprietary sub-broker Vruddhi had taken major sale position during 23.2.2001 upto March 1-2.2001 which impacted the downward price movement in these scrips. Since Satyam, MTNL, SBI and Infosys also form part of the stock indices, the fall in these scrips had triggered a decline in the index as a whole also.*

*FGSB also sold shares in considerable quantities during specific time periods of fall in the prices of index and momentum scrips, particularly on 23.2.2001, 1.3.2001 and 2.3.2001, mainly in the proprietary trading account of Vruddhi. It may be noted that the time slots were decided on the basis of the intra-day price movement in the scrips. The intra-day time periods where the scrip had witnessed comparatively sharp downward movement were picked up for analysis. The member had also cancelled orders during the specific time slots in an attempt to manipulate the scrip prices.*

*From the pattern of selling and the facts mentioned above it can be seen that the trading by First Global during this period has followed a consistent pattern. The*

consistency of the pattern makes it clear that there was intent of depressing market prices in these momentum stocks. This is in violation of SEBI Prohibition of Fraudulent and Unfair Trade Practices Regulations, 1995.

(2) *Violation of SEBI (Stock Brokers and Sub-brokers) Regulations, 1992*

*(a) Trading through unregistered Sub-broker*

Despite having memberships for both NSE and BSE, having large volumes of trading for various clients, Shankar Sharma had traded heavily through Palombe Securities, an unregistered sub-broker of Nirmal Bang Group. The trading pattern of Shankar Sharma through Nirmal Bang and other entities was of an irregular nature and indicative of an attempt to build up positions and avoid their detection. The quantum of such trades of FGSB Group is around Rs.600 Crore in the year 2000-01.

*(b) Abuse of Margining System*

FGSB abused the margining system at the exchanges, by declaring certain proprietary trades as institutional trades, at the time of order entry. This resulted into margin evasion to the extent of Rs.486.82 lakh at BSE. The member also dealt in a similar way at NSE. By indulging into such transactions FGSB not only evaded margin but also excluded these trades from gross exposure and intra-day trading limit. Thus FGSB over-stretched itself by resorting to these means. This aspect compounds the fact that FGSB not only traded with manipulative intent as explained earlier but also over-stretched itself in doing so.

These transactions violate provisions of the SEBI circulars which require payment of margins on all transactions other than trades by Institutional Clients. False declaration of trades as institutional trades violates provisions of the Code of Conduct For Stock Brokers (Regulation 7) under the SEBI (Stock Brokers & Sub-brokers) Regulations, 1992.

*(c) Non-compliance with summons and non-co-operation*

FGSB Group has intentionally and deliberately refused to reply to the queries raised by SEBI and has not complied with the summons issued by the investigation authority.

In regard to inspection of sales at NSE, instead of co-operating with NSE (where FGSB is registered as a trading member), FGSB had sought 3 months time from NSE to compile and furnish the necessary data. FGSB has been deliberately not co-operating with the exchange authorities thereby impeding the investigations.

*(d) Non-Compliance of SEBI Circular in regard to restriction on Sales*

According to a report submitted by BSE, FGSB had executed certain sale transactions in non-compliance with the SEBI circular dated March 07, 2001 which had placed certain restrictions on sales. The value of such sales in contravention of the SEBI Circular at BSE was around Rs.10 Crore.

*(e) Issuance of False Contract notes*

As per the information gathered from the Income Tax Department, FGSB had issued false contract notes (fictitious deals) for various clients for the purpose of profit accommodation to the tune of Rs. 2.9 crore.

3. *Violation of SEBI (Portfolio Managers) Regulations, 1993 and SEBI (Brokers and Sub-brokers) Regulations, 1992.*

*The RNA Group, which is primarily engaged in Construction activities also invests in the stock market. RNA Group placed around Rs. 20 Crore with First Global Stock Broking Pvt. Ltd. for the purpose of Arbitrage trading. FGSB had executed trades on behalf of RNA Group and apparently maintained an average minimum return on such trades. Trading done for RNA Group also shows that certain transactions are fictitious and the member had issued false contract notes to the clients in order to maintain the agreed rate of return.*

4.75 The Committee took oral evidence of Shri Shankar Sharma on 4.1.2002 and 1.4.2002.

4.76 During the deposition of Shri Shankar Sharma, the Committee enquired whether he had any intent of depressing the prices of some scrips with the intention of impacting on the market trend. Shri Shankar Sharma categorically denied any intention to depress the market prices. In addition he said that from mid Feb. to mid March 2001 FGSB was a net buyer to the extent of Rs.25 crore. He added that there were no contravention of rules on their part, no irregularity or false transaction.

4.77 With regard to volatility on the market that prevailed from about middle of 2000 till the crash occurred in March 2001, the witness said that his group turned bearish on the market from May, 2000. He further said, "We frankly read it right and we advised our retail customers to get out of the technology stocks and start buying old economy stocks like Cement and Reliance." When enquired whether unwinding of long position with a fairly accurate prediction about slide in prices would not impact the market prices, the witness admitted that "That is true". He however added that no sane trader would ever do it in a manner that would adversely impact the prices as it would increase his losses.

4.78 Later in a written reply FGSB stated that its trading volumes have been around 1% of the total trading volumes in the Stock Exchanges and this cannot impact the share prices. This is especially true of the scrips in which First Global is alleged to have manipulated prices like Satyam Computers, Global Tele-Systems, SBI, HFCL, Zee Telefilms, DSQ Software, Infosys, etc. These were among the most liquid scrips in the markets with volumes running, at times, into crores of shares per day. These scrips also had the lowest impact costs among all the scrips in the market. It is well known that scrips with low impact costs are least amenable to manipulation.

4.79 First Global also stated that SEBI has taken a very selective view in its report on FGSB highlighting only the 'Sale' transactions or positions and completely ignoring its 'Buy' transactions and positions. Asked whether he continued to hold long positions, Shri Sharma stated that "We have substantially long positions. We lost about Rs.6 crore in the Calcutta Stock Exchange default. We held HFCL 72,000 shares long, Global Tele 12,000, Silverline 20,000, DSQ Software 8,000."

4.80 Asked about the extent of his sales deferrals and their impact on the market trend, Shri Sharma said that his volumes were insignificant to make any impact on the market and added that to move prices of Global Tele and Himachal Futuristic by Rs. 20 or Rs.30, the quantities one had to transact have to be in hundreds of crore, not in Rs. 5 crore or 10 crore.

4.81 Asked about the reasons for doing trades through Nirmal Bang Group, the witness explained that in the event of their exposure reaching the cut-off limit they shifted their propriety trades to other brokers, utilising the exposure available to their Group for client trade. To enhance one's trading limits one can go from one to 25 cards depending on how much money one has

to finance those additional memberships. Alternatively, one can open an account with other brokers which is available for a commission of 10 paise per transaction. The witness also pointed out that there is no law prohibiting a broker from opening an account with other brokers. The witness also said that SEBI law is very clear that clients' trade should always take priority over proprietary trade.

4.82 Asked about his dealings with Palombe Securities, an unregistered Sub-broker of the Nirmal Bang Group, Shri Sharma categorically denied that he dealt with Palombe Securities and said, "We have never dealt with any entity called Palombe Securities. We have only dealt with Bang Equity. When I say 'we', I mean it is me in my personal capacity". The witness also said that Palombe Securities introduced them to the Nirmal Bang Group about two years back. First Global stated in a written reply in this connection that Shri Shankar Sharma's total trading volumes with Nirmal Bang were of order of Rs. 600 crore, which comes to Rs. 2 crore per day on average. The Market Turnover was Rs. 10,000-15,000 crore per day. Even as a percentage of FGSB's trading it amounts to only 2%.

4.83 In regard to the allegation of margin evasion, Shri Sharma stated that "On the BSE there was Rs.486 lakh margin evasion and on the NSE there was a Rs.1.8 lakh or Rs.1.9 lakh penalty imposed upon us for a similar margin evasion. The BSE figure is correct; no problems about that". Referring to margin violation, he further said that "In a high volume environment sometimes these amounts just get paid without even checking whether they are right or wrong because they come in very very small amounts. When we went back and checked we found that all the trades were actually institutional trades. Now we have written to the NSE saying that this amount was wrongly paid by us and it may kindly reverse the charges."

4.84 In regard to the allegation of issue of false contract notes, First Global stated in a written reply that allegation of IT Department is baseless and that no charge or allegation regarding this has been made in SEBI show cause notice. He pointed out that contracts get cancelled or rebooked in different people's name every day.

4.85 Regarding the allegation of misutilisation of client funds, Shri Sharma said that they used to take client money to do arbitrage trading for them. About the allegation of agreed rate of return to RNA Group, the witness said that the returns had varied from 5 per cent to 38 per cent and there was no fixed return as claimed by SEBI.

4.86 On the allegation that trading by First Global (Mauritius) of FGSB had shown a consistent selling pattern in the period Oct 2000 to Jan 2001, First Global stated in a written reply that all the transactions were part of GDR Arbitrage trades, where GDRs are purchased in overseas markets—in case their prices are lower—converted into local shares and sold in the domestic markets. This is a trading practice widely followed across the Securities Industry by all major players in the Indian markets like Jardine Fleming, Kotak Mahindra, etc.

## **(II) Action taken by SEBI**

4.87 On the basis of findings given in the Preliminary Report of SEBI, on 18.4.2001 SEBI issued an order under Section 11 B of SEBI Act barring Shri Shankar Sharma, Smt. Devina Mehra and the entities controlled by and connected with them, namely First Global Stock Broking Pvt. Ltd. and Vruddhi Confinvest India Pvt. Ltd. from undertaking any fresh business as a stock broker/sub-broker or merchant banker or portfolio manager till further orders are passed by SEBI. On 4.4.2001, High Court, Mumbai issued directions converting the order of 18.4.2001 to show cause notice. On 25.5.2001, SEBI issued an order under Section 11B barring Shri Shankar Sharma, Smt. Devina Mehra and the entities controlled by and connected with them from undertaking any fresh business pending enquiry proceedings under relevant regulations.

4.88 On 31.5.2001 SEBI initiated an enquiry into violation by First Global Group of the provisions of SEBI Act, Rules and Regulations. The Enquiry Officer submitted his report to the Board on 9.1.2002. The findings contained in the Enquiry Officer's report on First Global Group are summarised below:—

- (i) *The series of transaction indulged by the member over a period of time in large carry forward sales, short sales, etc. shows a course of conduct which amount to intentional interference with the normal functioning of the market. The result of acts, practices and course of conduct of the member over a period of time has led to the fall in the share prices, which can be termed as artificial depression of prices.*
- (ii) *Out of 9 transactions involving sale of shares by FGSB during specific time bands, it is seen that in three instances involving the sale of Wipro at BSE on 23.2.2001 and 27.2.2001, the short sale by the member during the specific time slots had caused the price fall. No evidence was forthcoming for the 3 transactions and in other 3 transactions, there is no sufficient evidence to establish the charge. Therefore the charge is established to the extent of three transactions. This is in violation of Regulation 4(a) of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to securities Markets) Regulations, 1995 which states that no person shall effect, take part in or enter into, either directly or indirectly, transactions in securities with the intention of artificially raising or depressing the prices of securities and thereby inducing the sale or purchase of securities by any person.*
- (iii) *It is concluded that FGSB was dealing in securities through a unregistered sub-broker which is unbecoming of a registered Stock-broker.*
- (iv) *It is noticed that the transactions between FGSB and Bang Equity are synchronised transactions in view of the close proximity of the order time punched by both the parties in the system. Such transactions are highly irregular and defeat the purpose of normal order-matching system in the price discovery process in the Exchanges and would also be in violation of Regulation 4(c) & (d) of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to securities market) Regulations, 1995.*
- (v) *It is concluded that Vruddhi, FGSB and Bang Equity were acting in concert with each other in the synchronised deals.*
- (vi) *Regarding transactions in RNA Group, it has been observed that there was a guarantee that no losses would ever be passed on to the party but borne by the Portfolio Manager. Such arrangement amounts to discretionary Portfolio Management Services with a guarantee that there would be no losses. This is not in conformity with Regulation 14(3) of Portfolio Manager Regulations.*
- (vii) *It is concluded that FGSB had undertaken short sales in securities after 8.3.2001 which is not in conformity with the Circular of SEBI and the quantum of such short sales are also quite high.*
- (viii) *The charge relating to evasion of margins by FGSB by showing certain trades as institutional trades though they were not institutional trades and thereby avoiding payment of margins, etc. has been established.*

4.89 On the basis of the recommendation of the Enquiry Officer, registration of First Global Stock Broking Pvt. Ltd. as Stock Broker and Portfolio Manager and Vruddhi Confinvest as Sub-broker is stated to have been cancelled.

4.90 Prosecution proceedings have been initiated against First Global Stock Broking Pvt Ltd., Vruddhi Confinvest India Pvt. Ltd., Shankar Sharma, Devina Mehra, Virta Trade Agencies Pvt. Ltd. and First Global Finance Pvt. Ltd.

### (III) Involvement in HFCL Private Placement

4.91 According to the Enforcement Directorate, there were violations of Foreign Exchange Regulations by the First Global in the sale of HFCL shares. In the private placement issue of HFCL shares in March 2000, a total of 10,69,275 shares were allotted in the name of eight companies, six of which belonged to FGSB associated companies. The ED has reported that these shares were disposed of as follows :

- (i) Out of these shares, 5,92,950 shares were allotted to 16 FIs/sub-accounts through HSBC and Citi Bank, Mumbai during March 2000 in off-market transactions.
- (ii) Out of the remaining shares, M/s First Global Stock Broking Pvt. Ltd. attempted twice to sell 2,37,600 shares to four FIs/sub-accounts during March 2000 through Deutsche Bank, Mumbai in off-market transactions, but the transactions were not allowed by the Bank. Finally, during April 2000 these shares were sold to the same FIs/sub-accounts through stock exchange at Mumbai at the prevailing market rate and the transactions were duly allowed by Deutsche Bank. According to ED, the prevailing market rate at that time was Rs.1937 to Rs.2211.
- (iii) As regards the remaining 2,38,725 shares, the same were sold by M.s First Global Stock Broking Pvt. Ltd. in the local market.

4.92 The names of the FGSB associated companies involved in HFCL private placement and number of shares allotted as informed by FGSB is given below:

Name of the Company	Shares	Date of Transaction	Delivery Date
1. U.D. & M.D. Agencies Pvt. Ltd.	1342,500	3.3.00	25.3.00
2. Top Gear Leasing & Finance Pvt. Ltd.	70,125	3.3.00	25.3.00
3. Panchal Components & Appliances Pvt. Ltd.	142,675	3.3.00	25.3.00
4. Vruddhi Confinvest India Pvt. Ltd.	142,450	3.3.00	25.3.00
5. Virta Trade Agencies Pvt. Ltd.	142,525	3.3.00	25.3.00
6. First Global Stockbroking Pvt. Ltd.	142,750	3.3.00	25.3.00

4.93 According to FGSB, the source of funds of subscribing to the placement was owned funds and working capital facility from Global Trust Bank. The sale of the subscribed shares was reportedly done at an all in price ranging between Rs.1060/- and Rs.1075/- per share.

4.94 The preferential allotment of shares to FIs requires prior permission from the Reserve Bank of India as the price at which the shares are to be issued to the FIs is to be approved by the Reserve Bank. The Committee observed from the information furnished by RBI that on 3.2.2000, RBI had granted 'in-principle' approval to HFCL to issue 75,00,000 equity shares of Rs.10.- each at a premium of not less than Rs. 401/- per share to FIs on a preferential basis. On 16.3.2000, RBI issued final permission to HFCL under Section 19(1) (d) of FERA, 1973 to issue

27,04,350 equity shares of Rs.10.- each for cash at a premium of Rs.1040.- per share to 40 FIs as per list submitted by HFCL. It also permitted those 40 FIs to acquire the shares under section 29(1) (b) of FERA, 1973. The list however, does not include 20 FIs/sub-accounts which purchased shares of HFCL from First Global Stock Broking.

4.95 RBI has stated that First Global Stock Broking Ltd. (FGSB) approached them on 29.5.2000 with the request for remittance of profit amounting to Rs. 2,67,14,268 to three sub-accounts of an FII—Nicholas Applegate Capital Management (NACM), on the ground that FGSB had purchased 1,58,900 shares of HFCL on behalf of the 3 sub-accounts of the FI at a price of Rs.1060.50 and that later it had to sell the shares to NACM at the market price of Rs.1228.62.

4.96 FGSB's request was based on its statement that NACM could not participate through the normal Escrow Mechanism because they required a delivery vs. payment transaction due to the participation of US registered management investment companies (Mutual Funds) in the transaction and that in the absence of delivery vs. payment facility, FGSB had structured NACM's transactions as a delivery vs. payment trade where by FGSB put up the capital to take stock allocated to NACM at a price of Rs. 1050/- per share and then was to sell it to NACM at a price of Rs. 1060.50 per share. It was further stated that in terms of SEBI's circular issued in late February 2000 old and new shares would carry the same distinctive code thus the new shares became listed automatically, so all transaction norms relating to listed security transactions became applicable. Accordingly, the shares were then sold by FGSB to NACM at a rate of Rs. 1228.62 per share. The difference in the two prices was sought to be remitted by FGSB to Nicholas Applegate Capital Management. RBI did not approve the application and the remittance was not permitted by RBI letter dated 17.7.2000.

4.97 Elaborating the above point, a representative of RBI said during evidence :

"FGSB applied to the Exchange Control Department to remit the profit gained by some FIs on behalf of whom they had undertaken a deal to purchase shares of HFCL. This was something in contravention of the Exchange Control regulations because FIs are required to purchase from the stock exchanges only or they have to come to the RBI for prior approval. Since this has not been done, we rejected their application to remit this amount."

4.98 Shri Shankar Sharma however, claimed that "we, as brokers, are not required to seek permission from the RBI.... The designated banks and the foreign buyers are the only two people as per the settled law of the Supreme Court who are supposed to take permission before transacting in India in the selling of the stock". He regretted that the Enforcement Directorate has not charged the designated banks but has filed a case against him.

4.99 The Committee observed that eight companies including the six associated companies of Shri Shankar Sharma availed of credit facilities from the Global Trust Bank to the extent of over Rs. 119.73 crore in March 2000 by issue of Non-convertible debentures (NCD) to GTB. It is also observed from the subscription agreement signed on 2.3.2000 between the Global Trust Bank and each of the above mentioned six FGSB associated companies that there was a condition regarding utilization of proceeds of the debentures to the effect that the company shall utilize the aggregate subscription amount towards its working capital requirements and that the proceeds shall not be utilized by the company for the purpose of subscription or purchase of shares and debentures, etc. During the oral evidence of Shri Sharma, when the Committee drew his attention to this condition, Shri Sharma stated, "What it says is that, as I cannot be an investor, I cannot purchase it for my own account. I cannot use it to take a position in a stock with the hope that the stock goes up tomorrow and I can sell it at higher price. We have simply done a working capital transaction and it is meant for working capital. In a stock broking firm

or financial firm, working capital is to take a delivery of good or service and deliver it down to the end buyer. The difference in the two things is your commission or your interest. We have been faithful to that.”

4.100 It is observed from the fact sheets of GTB that the main line of business of four out of the six companies was trading of components.investment.leasing.trading of components and nothing to do with stock broking or equity placement. It, therefore, appears that the credit facility availed of from GTB was not used for working capital purposes but used for purchase of HFCL shares. This appears in violation of the agreement with GTB.

4.101 The Committee noted from the copies of share applications made to HFCL by each of the six FGSB associated companies that they were applying for shares as a “Body Corporate”. They had not given any information in the column against Foreign Institutional Investor. The Committee enquired during evidence of Shri Sharma, if First Global was buying HFCL shares on behalf of FIIs why it was not mentioned so in the share applications. Shri Sharma in response said. “I cannot mention as FIIs.” The Enforcement Directorate has stated that as per Shri Shankar Sharma’s statement the management of HFCL was never informed that shares were being purchased for FIIs or DVP basis.

4.102 RBI stated in a post evidence reply that the bank accounts of the FGSB, its group companies and directors and the FIIs have been blocked by them and also by the Enforcement Directorate.

4.103 The information furnished by the Enforcement Directorate in August 2002 indicates that show cause notices have been issued to FGSB, Shri Shankar Sharma and Smt. Devina Mehra for the purpose of adjudication in regard to the following:-

1. Sale of 5,92,950 shares of HFCL and further by attempting to sell further 2,37,600 shares of HFCL, without any general or specific permission of RBI, in contravention of the provisions of section 19(1) of FERA, 1973.

2. (i) Failure to comply with the conditions stipulated by RBI regarding holding of 100% equity shares of M.s First Global (UK) Ltd.

(ii) Otherwise acquisition of US\$ 11.79 lakh in violation of provisions of section 8(1) of FERA, 1973 and 9(1)(f)(i) of FERA, 1973.

4.104 In both the above matters, criminal complaints have also been filed. The Enforcement Directorate has further informed that transactions relating to period after 31.5.2000 (FEMA) are still under investigation and summons under section 37 of FEMA, 1999 have been issued to Smt. Devina Mehra and Shri Shankar Sharma.

4.105 The Enforcement Directorate has further stated that 16 FIIs/sub-accounts have been charged under Section 29(1)(b) of FERA, 1973 relating to the purchase of 5,92,950 shares of HFCL from First Global Stock Broking Pvt. Ltd. without specific approval of RBI. Four FIIs/sub-accounts have also been charged under Section 29(1)(b) of FERA, 1973 read with section 64(2) of FERA, 1973 for attempted purchase of 2,37,600 shares of HFCL from First Global Stock Broking Pvt. Ltd. without specific approval of RBI.

## **B. CSFB Securities**

4.106 As per SEBI report, Credit Suisse First Boston (I) Securities Pvt. Ltd. (CSFB Securities) reportedly transacted in a big way on behalf of entities connected.associated with Ketan Parekh,

certain OCBs namely Wakefield, Brentfield, Kensington, FII sub-account—Kallar Kahar Investment Ltd., Mackertich Consultancy Services Pvt. Ltd. and also on its own account.

4.107 SEBI's investigation have concluded that CSFB Securities and CSFB proprietary account aided and abetted Ketan Parekh entities in putting fictitious and non-genuine trades with a view to create misleading appearance of trading. Credit Suisse First Boston also aided, assisted and abetted Ketan Parekh entities in creating artificial volumes and market in certain scrips through circular trades. Shares were being rotated from one entity belonging to Ketan Parekh to other entities belonging to him. There was no change in beneficial ownership. These transactions were put with a view to induce others to purchase and sell the securities.

4.108 SEBI had issued orders against CSFB asking it not to undertake fresh business as a broker. Enquiry proceedings have also been completed against the broker and the Board has imposed the penalty of suspension of registration certificate as a broker for three years.

### **C. DKB Securities**

4.109 Dresdner Kleinwort Benson Securities (India) Ltd., (DKB Securities), a foreign brokerage registered with SEBI is also found to have aided and abetted Ketan Parekh entities in putting fictitious and non-genuine trades with a view to create misleading appearance of trading. According to SEBI, DKB Securities also aided, assisted and abetted Ketan Parekh entities in creating artificial volumes and market in certain scrips through circular trades. Shares were being rotated from one entity belonging to Ketan Parekh to other entities belonging to him. There was no change in beneficial ownership. These transactions were put with a view to induce others to purchase and sell the securities. Enquiry proceedings are reportedly being initiated against DKB Securities.

### **D. Consortium**

4.110 It was *prima-facie* observed by SEBI that Consortium Securities Ltd. and CSL Securities Pvt. Ltd. (CSPL), which are referred to as Consortium, traded for entities linked to Ketan Parekh, Shankar Sharma and Nirmal Bang. The Consortium facilitated shifting of positions from one Ketan Parekh entity to another Ketan Parekh entity and other entities *per se* which appeared to be in the nature of synchronized order placement. The inspection of the records of consortium show that the trading discipline and regulatory instructions were breached on several fronts in violation of SEBI regulations. Enquiry proceedings were proposed to be initiated against the broker.

### **E. Khemani Group**

4.111 SEBI has reported though Khemani Group have not defaulted in meeting their pay-in obligations at CSE, Khemani Group was one of the groups through which Ketan Parekh and his groups.associate entities have done substantial trading in Kolkata. The group consists of Shri Sanjay Khemani, Shri N. Khemani, Khemani Securities Pvt. Ltd. and Khemani and Sons. SEBI's investigations indicate that Khemani group had done huge volume of off-the floor transactions. Off-the floor transactions are permitted if they are in the nature of spot delivery contracts and they are required to be reported by brokers to the stock exchange. SEBI has stated that the volume of the off-the floor transactions reported to CSE seemed to be small. Based on its investigation findings, SEBI has ordered an enquiry against Shri Sanjay Khemani under SEBI (Stock Brokers) Regulations, 1992 and prosecution proceedings under section 24 of SEBI Act, 1992 and 23 (1) (c) & (i) of SCR Act, 1956 against Shri Sanjay Khemani and Shri N. Khemani have also been ordered.

## **F. Damani Group**

4.112 SEBI's investigations have brought out the indulgence of this group in concerted selling of shares at the stock exchanges leading to fall in the share prices and consequently the index and interfering with fair and smooth functioning of the market. Enquiry proceedings have reportedly been initiated by SEBI against Shri R.S. Damani and the associated entities of the group i.e. Damani Shares & Stock Brokers Pvt. Ltd. Maheshwari Equity Brokers Pvt. Ltd. and Avenue Shares and Stock Brokers Pvt. Ltd.

## **G. Shailesh Shah Group**

4.113 As per SEBI report, the Shailesh Group had entered into certain irregular trades by way of matched trades in violation of SEBI guidelines and also dealt in the scrip of one of its group companies namely Dolat Investments Ltd. without reporting to SEBI as required under SEBI (Substantial Acquisition of Share and Takeovers) Regulations, 1998. SEBI has initiated an enquiry against Shailesh Shah and his associated registered intermediaries namely M/s. Shailesh Shah Securities Ltd., M/s. Dolat Capital Markets Ltd., M/s Nirpan Securities Ltd., and M/s. Pankaj D Shah for unauthorized negotiated deals.

## **H. Bang Group of Entities**

4.114 According to SEBI, Bang Equity and First Global have indulged in fictitious dealings by giving false orders for purchase and sale of securities the execution of which involved no change of ownership. They were artificially shifting positions and creating false volumes in the market. This has resulted in upsetting the equilibrium of the market. Major scrips involved in these transactions include Satyam, Zee TV, Infosys, Jaiprakash, HFCL and Silverline.

4.115 SEBI banned naked short selling by brokers (without backing by delivery) from 8.3.2001 onwards. During the investigation for the period 8.3.2001 30.3.2001, it was observed that the stock brokers Nirmal Bang Securities Pvt. Ltd. and Bang Equity Broking Pvt. Ltd., indulged in short sales during this period almost each day in gross violation of directive issued by SEBI. SEBI also reported about other violations by these entities such as dealing with unregistered sub-brokers, non-issue of sales/purchases confirmation notes and non-maintenance of client agreement forms. SEBI, on the basis of an enquiry, has since cancelled the registration of Nirmal Bang Securities and Bang Equity Broking Pvt. Ltd. on 30.7.2002.

## **I. Ajay Kayan, BLB Ltd. and JM Morgan Stanley**

4.116 SEBI also conducted investigations in respect of Ajay Kayan Group, BLB Ltd. and JM Morgan Stanley Group in connection with the Stock Market Scam. SEBI has not, however, found any serious irregularities in respect of these brokers.

**4.117 SEBI has not so far provided conclusive evidence to substantiate its conclusions in regard to the brokers/groups mentioned in section 3 above. Accordingly, the Committee recommend further investigations in this regard.**

## **4. STOCK HOLDING CORPORATION OF INDIA LTD. (SHCIL)**

4.118 SHCIL, promoted by all India Financial Institutions viz. IDBI, UTI, IFCI, LIC, etc. is registered with SEBI as a custodian of securities, depository participant and approved intermediary for stock lending. SHCIL introduced in January, 2000 a scheme called Sell-n-Cash scheme (SAC) under which SHCIL takes over the settlement responsibility for dematerialized shares sold and

pays the investors on the same day. SHCIL introduced in August 2000 another scheme called Cash on Payout (COP) Scheme. As per the scheme an investor can sell his shares through one of the empanelled brokers of SHCIL and the payment is released to the investor on the next day of the payout.

4.119 Under SAC.COP schemes, there were two transactions by Shri H.C. Biyani, member of Calcutta Stock Exchange (CSE)—one was on 1.3.2001 regarding sales of 2.4 lakh shares of DSQ Industries Ltd. for Rs. 8.04 crore and another was on 2.3.2001 regarding sale of 7.2 lakh shares of DSQ Industries for Rs. 24.48 crore. SHCIL made payment against the first transaction to Shri Biyani on the same day and regarding the second transaction, it released the payment through a post dated cheque to Shri Biyani who discounted the cheque with IndusInd Bank, Kolkatta and received the sale proceeds. In the transaction dated 1.3.2001 financed by SHCIL for the client Shri H.C. Biyani, the Counter party broker was Shri H.C. Biyani itself. In the transaction dated 2.3.2001 assured/facilitated by SHCIL for the Client Shri H.C. Biyani, the Counter Party brokers were Shri H.C. Biyani, Arihant Exim and DoeJones CSE classified these trades as trades in the nature of accommodation and expunged the same. For an earlier Sell-N-Cash transaction valued at Rs. 34.84 crore by Shri Biyani on 27.2.2001, payout was made by CSE.

4.120 SHCIL made a complaint to SEBI regarding the non-receipt of Rs. 8.03 crore from CSE in regard to first of the above two transactions. SEBI conducted an inspection in May, 2001 to look into, among other things, the transactions under SHCIL's Sell-N-Cash Scheme (SAC) especially the transactions with Biyani Group of CSE. Having observed the facts about the two transactions mentioned above, SEBI's inspection concluded that the claim of CSE against CSE was a commercial dispute. It appears that there was no attempt on the part of SEBI to examine whether SHCIL's dealings in the above transactions were in order.

4.121 It transpired during the Committee's examination that Shri M. Ramesh, Manager (Vigilance and Security) in SHCIL had been sent to Kolkatta by the management in August 2001 to assist and follow up the criminal complaint filed by SHCIL in regard to transactions of Shri H.Biyani. Shri Ramesh's report to the management in September, 2001 had brought out certain irregularities on the part of SHCIL's in respect of these transactions. As the report portrays SHCIL in a negative light, Shri Ramesh was being prosecuted by SHCIL.

4.122 One of the allegations made by Mr. Ramesh was that BSPL was not an empanelled broker when these transactions were conducted between 27.2.2001 and 2.3.2001 and that empanelment papers have been subsequently submitted by them with back date. According to SEBI's inspection of July 2002, it appears that while the empanelment agreement was executed on 23.2.2001, the empanelment fee was received only on 22.3.2001 which is subsequent to the trades. SEBI's report has stated that Shri Dinesh Dalmia alongwith Shri Ravindra Biyani visited SHCIL Mumbai office on 2.3.2001 and negotiated regarding SAC facility for H.C. Biyani. During the oral evidence of SHCIL, the MD, SHCIL (Shri B.V. Goud) admitted that Shri Dalmia and Shri Ravindra Biyani approached and requested for additional amount under the Sell-N-Cash Scheme. This was refused. Instead, Cash-on-payout facility was extended. According to SEBI this is a unique transaction where promoter of a company has accompanied investor to a financier's office in respect of trade being conducted on the floor of the stock exchange in the shares of his company.

4.123 Another observation made in the Report of Shri Ramesh was that it was the first time, cheques were issued at Kolkatta with particular Account Number, Name of the Bank and both the officials who issued the cheques were not authorised signatories to the said account as on 2.3.2001. These were confirmed as facts by the MD, SHCIL during his oral evidence before the Committee.

4.124 The Committee took oral evidence of SHCIL on 9.4.2002 and 6.6.2002. Enquired whether the SAC scheme was confined only to retail clients as originally envisaged, the MD, SHCIL (Shri B.V. Goud) stated that all investors other than institutions were treated as retail investors. Asked whether broker is an investor, the witness said, that broker in his individual capacity is entitled. Referring to the letter of comfort issued by Kolkatta office of SHCIL to IndusInd Bank, the Committee enquired whether it was a sound commercial judgement on the part of SHCIL. In response, the witness said that, "I do agree that letter should not have been issued by our Kolkatta office" and added that the letter was issued by the Kolkatta office without being referred to Head Office. To another query whether the empanelment cheque which had been originally dated as 3.3.2001 was scored off and made 23.2.2001, the witness replied in affirmative and clarified that the business started from the date they signed the agreement and the empanelment fees was for the purpose of providing smart card, smart card reader, etc.

4.125 A statement is sent by SHCIL to its institutional clients showing their holdings. The Committee enquired whether sensitive information from this statement could be collected and used in the Stock market for manipulation, the MD, SHCIL said, "Sir, we do not know that." When his attention was drawn to an allegation that certain senior officials in the organization were passing on information, the witness said that it was not so. He also said that during the last five years whenever SHCIL got information about leakage of information having taken place, SHCIL had taken action and dismissed two officers for this.

4.126 The Committee drew attention of the witness to the order of the Debts Recovery Tribunal, Kolkatta dated 12.2.2002 on the application filed by IndusInd Bank against SHCIL and H.C. Biyani regarding issue of post dated cheque worth Rs.24.40 crore. The order had indicated among other things that there might also be negligent conduct on the part of officers of SHCIL. The Committee asked what penal action was taken by SHCIL on the officials indicted of negligent conduct. In response, the MD, SHCIL stated that an internal investigation was done and no mala fide was involved.

4.127 When the Committee pointed out that they did not consider it a right step that in the light of stricture by a Tribunal an organization conduct an investigation and exonerate people, the MD, SHCIL said that he was prepared to order an inquiry. The Committee directed that the enquiry should be an independent and outside enquiry. In deference to the direction of the JPC, SHCIL Board on 5.7.2002 appointed Haribhakti & Co. to look into this case and ascertain whether there was any negligence or possibility of malafide intentions on the part of the officials including the Managing Director of SHCIL in the matter.

4.128 During the oral evidence of SEBI on 27.6.2002, the Committee pointed out that SEBI's inspection of SHCIL in May 2001 had not brought out any thing about the role of SHCIL in the 2 transactions of Shri H.C. Biyani which were in the nature of accommodation. Taking note of the above observations of the Committee, SEBI conducted another inspection of SHCIL in July 2002 and furnished an interim report to the Committee. SEBI in its interim report of inspection has stated that the objectives of fairness, transparency and integrity appeared to have been set aside by SHCIL management in order to assist and abet fraudulent and unfair trade practices. SEBI has further stated that SHCIL did not follow prudential norms and regulations while conducting its business. The summary of irregularities observed by SEBI is as under:

- (i) *The SAC Scheme of SHCIL it was envisaged as a scheme predominantly for small investors. However, SHCIL has extended this facility freely to brokers and their related entities. The SAC scheme appears to have been used as an avenue for financing brokers.*

- (ii) Till March, 2001, SHCIL had no specific risk management norms in the following areas:
- Scrip wise exposure limits
  - Broker wise exposure limits
  - Stock Exchange wise exposure limits
  - Exposure limit in respect of SHCIL's net worth
  - All types of scrips irrespective of their liquidity level were allowed to be financed/facilitated under their schemes.
- (iii) Further there was lack of internal control procedures at SHCIL due to which for a certain transaction of H.C. Biyani of a very high value, trades were executed even before the shares came into the client's beneficiary account.
- (iv) In respect of the transactions done by SHCIL under SAC.COP schemes for Biyani Securities Pvt. Ltd. (BSPL) and H. Biyani (HB), it was observed that it had over extended itself. As on 1.3.2001 SHCIL's total exposure on HB and BSPL was Rs.42.88 crs. Which was 1.3rd of its net worth. And this exposure was only in one scrip, one stock exchange and to one broker group. All the transactions of HB and BSPL were in the scrip of DSQ Industries that too in the rolling segment of CSE where the scrip was not liquid speaks of lack of market intelligence/surveillance on the part of SHCIL. Apart from this SHCIL has admitted that there was no use of the COP scheme for brokers. Yet it extended this facility to HB. There were only 1,10 lakh shares of DSQ Industries Limited in the beneficiary account of HB on the morning of 2.3.2001. The balance 6.10 lakh shares have been credited to HB's beneficiary account through off market transfers from DSQ group companies after the trade was done. It appears that after SHCIL agreed to facilitate HB's transaction under COP on 2.3.2001, after discussion with Shri Dinesh Dalmia and Shri Ravindra Biyani, instructions were passed to transfer the shares from DSQ group companies to HB's pool A.c. SHCIL, Kolkatta office also issued a letter of comfort.assurance to IndusInd Bank, a practice which is generally not followed in India. SHCIL Head Office also confirmed the issuance of the cheques. SHCIL also reduced the service charge to 0.2% instead of 0.5% charged from other clients. All the above aspects/incidents indicate that SHCIL went out of its way to help HB and BSPL. SHCIL Calcutta officials indicated that Dinesh Dalmia had contacted SHCIL officials in Mumbai for the SAC transaction done by HB.
- (v) For the transactions of 10.40 lakh shares on 27.2.2001 and 2.40 lakh shares on 1.3.2001, the seller was BSPL/HB and the buyer was also HB. These appear to be collusive trades and SHCIL should have been more vigilant before taking such transactions.
- (vi) It was also observed that Vivenasari Financial Services Ltd. had done large transactions under SAC in certain scrips like Datasoft, Vision Technology, and Zodiac Clothing etc. From the trading pattern of Datasoft it seems that VFSL had used the scheme as a funding mechanism for creating artificial market in the scrip.
- (vii) Further two of Ketan Parekh entities had sold 2 lakh shares of Adani Exports under SAC amounting to Rs.9.70 crs. through broking entities associated with/connected with Ketan Parekh and the counter party for these transactions was either another client of the same broker or another entity connected with Ketan Parekh.

4.129 SEBI has stated that it need not prescribe/monitor the norms for the various activities, which are not under SEBI purview. SEBI has, however, emphasized that SHCIL should devise

appropriate norms to ensure that its scheme activities do not result in market manipulation or promote unfair trade practices.

4.130 Investigation taken up by special cell (G.S.) of Detective Department, Calcutta Police has indicated that Shri B.V. Gaud, the then Managing Director, SHCIL had dishonestly by and fraudulently allowed "Sell-N-Cash" and "Cash-on-Payout" schemes to be misused by the promoter of DSQ Group of Industries namely Shri Dinesh Dalmia and his associate broker all having close acquaintance for their wrongful gain by way of circular & inside trading among the accused brokers, promoters and their associates.

4.131 The Committee note that SEBI inspection has brought out various irregularities by Stock Holding Corporation of India Ltd. (SHCIL) in respect of its transactions under 'Sell-N-Cash'/'Cash-on-Payout' schemes with Biyani Group of Calcutta Stock Exchange. Some of the irregularities are :—

- Exposure of one-third of its net worth (exposure of about Rs. 43 crore) for one scrip and one broker group viz., Biyani Group;
- Doing trade of 7.2 lakh shares when there were only 1.1 lakh shares in the beneficiary account;
- Negotiating with promoter Director of the traded scrip for extension of a facility to a broker;
- Issue of a letter of comfort/assurance to IndusInd Bank by local office followed by Head Office regarding issuance of cheques;
- Issue of cheques by unauthorized signatories;
- Reduction of service charge from 0.5% to 0.2%.

The Committee hope that SEBI will take suitable action on the basis of its above findings.

4.132 SHCIL at the instance of JPC instituted an independent enquiry to look into this case. The enquiry was conducted by a Chartered Accountant (Haribhakti & Co.). The enquiry has concluded that though the Sell-N-Cash scheme was not meant for brokers, SHCIL extended the facility to brokers and that the procedures laid down were not followed. The limits laid down were exceeded and such excesses were ratified by the then Managing Director and C.E.O. The enquiry has concluded that while they have not come across any evidence to indicate malafide intention on the part of officials of SHCIL, there was negligence in operation of the schemes and lack of proper judgement on the part of the Managing Director and C.E.O. in approving the transaction and not keeping the Board informed in advance. The enquiry report has recommended certain corrective measures such as review of the Sell-N-Cash and Cash-on-payout Schemes, restricting the schemes only to investors, etc. The Committee urge that necessary action be taken on the measures suggested by the enquiry.

4.133 SEBI's report has highlighted that SHCIL did not follow prudential norms and regulations while conducting its business. The 'Sell-N-Cash' Scheme envisaged for small investors has been used by SHCIL as an avenue for financing brokers and used as a funding mechanism for creating artificial market in scrips. There was also lack of internal control procedures. The Committee urge SHCIL to look into these issues and devise appropriate norms to ensure that its schemes/activities do not result in market manipulation or promote unfair trade practices.

## CHAPTER V

### BANKS

#### 1. OVERVIEW

5.1 Banks provided a significant source of funds for infusion into the stock market. The Committee have examined in detail the role of some of the banks alleged to have been involved in the manipulation of prices in the stock market. In the Banking Sector, we have three kinds of banking entities: First, the Cooperative Banks whose activities are controlled by the Reserve Bank of India as well as the Registrar, Cooperative Societies. Second, Private Sector Banks. Third, Public Sector Banks. All categories are subject to the provisions of the Banking Regulation Act, 1949. The Reserve Bank of India, by virtue of the powers vested in it under the Reserve Bank of India Act, 1934, is also charged with the responsibility under the said Act to regulate the banking sector.

5.2 The Committee's investigation has revealed that the activities of some Urban Co-operative Banks (UCBs) were manipulated by virtue of their nexus with broker-entities; and in the absence of careful regulation, such broker-entities used large funds provided by UCBs to manipulate the stock market. The acquisition of substantial funds from the Madhavpura Mercantile Cooperative Bank leading to defaults in payment, led to the arrest of Ketan Parekh by the CBI. This significant act led to a run on the bank which, in turn, had a negative impact on the stock market. The management of a few Private Sector Banks through brokering firms closely connected with certain individual brokers also manipulated the stock market and contributed significantly to the crisis. Some Private Sector Banks were involved in granting huge advances to brokers contrary to acceptable norms which resulted in the infusion of finance in the capital market allowing artificial manipulation of prices in the stock market. The contributory role of the Public Sector Banks in the stock market crisis being investigated by the Committee is not perhaps significant in comparison to the role of Cooperative Banks and Private Sector Banks.

5.3 The data received from RBI on Capital Market exposure by way of investments in equity shares/financing of IPOs as also the total capital market exposure of the banks for years ended 31.3.1999 to 31.3.2002 is as under:

(Rs. in Crore)

#### Position as on March 31, 1999

Sr. No.	Name of the Bank	Investment in equity	Advances for financing in IPOs	Total exposure to capital market
1	2	3	4	5
1.	Global Trust Bank Ltd.	22.56 (1.06%)	0.00 (0.00%)	374.51 (17.68%)

1	2	3	4	5
2.	ICICI Bank Ltd.@	32.77 (1.55%)	0.00 (0.00%)	44.34 (2.10%)
3.	Bank of Madura Ltd.*			
4.	UTI Bank Ltd.	11.77 (0.54%)	0.00 (.00%)	42.02 (1.92%)
5.	Karnataka Bank Ltd.	74.63 (3.65%)	2.52 (0.12%)	77.15 (3.77%)
6.	Bank of America	0.06 (0.02%)	0.00 (0.00%)	0.06 (0.00%)
7.	Development Credit Bank Ltd.	0.34 (.03%)	0.00 (.00%)	1.48 (0.14%)
8.	HDFC Bank Ltd.	14.66 (0.96%)	0.00 (0.00%)	167.63 (11.02%)
9.	Bank of Pubjab Ltd.	8.52 (1.00%)	0.00 (0.00%)	25.12 (2.94%)
10.	Centurion Bank Ltd.	1.17 (0.07%)	0.00 (0.00%)	
11.	IndusInd Bank Ltd.	17.47 (0.66%)	0.00 (.00%)	119.80 (4.50%)
12.	Nedungadi Bank Ltd.@@	0.87 (0.13%)	0.00 (0.00%)	13.68 (2.08%)

**Position as on March 31, 2000**

Sr. No.	Name of the Bank	Investment in equity	Advances for financing in IPOs	Total exposure to capital market
1	2	3	4	5
1.	Global Trust Bank Ltd.	27.36 (.085%)	127.85 (3.98%)	1265.85 (39.42%)
2.	ICICI Bank Ltd.@	9.82 (0.27%)	116.00 (3.17%)	146.61 (4.01%)
3.	Bank of Madura Ltd.*			
4.	UTI Bank Ltd.	20.54 (0.58%)	1.72 (0.05%)	105.79 (2.99%)
5.	Karnataka Bank Ltd.	120.43 (4.91%)	1.99 (0.08%)	122.42 (4.99%)

1	2	3	4	5
6.	Bank of America	0.06 (0.002%)	0.00 (.00%)	0.06 (.00%)
7.	Development Credit Bank Ltd.	0.34 (.03%)	0.00 (.00%)	3.61 (.022%)
8.	HDFC Bank Ltd.	34.77 (0.95%)	0.00 (.00%)	415.53 (11.33%)
9.	Bank of Pubjab Ltd.	18.32 (1.39%)	343.47 (26.04%)	463.69 (35.15%)
10.	Centurion Bank Ltd.	27.48 (1.27%)	0.00 (.00%)	360.58 (16.64%)
11.	IndusInd Bank Ltd.	22.44 (.061%)	0.00 (.00%)	180.07 (4.90%)
12.	Nedungadi Bank Ltd.@@	0.95 (0.12%)	0.51 (.06%)	62.58 (7.69%)

**Position as on March 31, 2001**

Sr. No.	Name of the Bank	Investment in equity	Advances for financing in IPOs	Total exposure to capital market
1	2	3	4	5
1.	Global Trust Bank Ltd.	58.97 (1.78%)	—	836.31 (25.21%)
2.	ICICI Bank Ltd.@	14.28 (0.39%)	27.07 (0.73%)	397.73 (10.62%)
3.	Bank of Madura Ltd.*			
4.	UTI Bank Ltd.	44.85 (1.26%)	5.67 (.016%)	622.83 (17.52%)
5.	Karnataka Bank Ltd.	9.39 (0.37%)	—	98.15 (3.86%)
6.	Bank of America	0.06 (.002%)	—	0.06 (0.00%)
7.	Development Credit Bank Ltd.	0.34 (.02%)	—	119.46 (7.17%)
8.	HDFC Bank Ltd.	36.88 (1.05%)	—	757.92 (20.27%)
9.	Bank of Pubjab Ltd.	46.84 (3.55%)	—	200.52 (15.14%)

1	2	3	4	5
10.	Centurion Bank Ltd.	53.48 (2.80%)	—	452.11 (23.66%)
11.	IndusInd Bank Ltd.	10.89 (0.29%)	—	237.53 (6.38%)
12.	Nedungadi Bank Ltd.@@	6.72 (0.83%)	—	63.30 (7.78%)

**Position as on March 31, 2002**

Sr. No.	Name of the Bank	Investment in equity	Advances for financing in IPOs	Total exposure to capital market
1.	Global Trust Bank Ltd.	122.66 (2.93%)	—	442.94 (10.59%)
2.	ICICI Bank Ltd.@	18.31 (0.25%)	—	227.12 (3.02%)
3.	Bank of Madura Ltd.*			
4.	UTI Bank Ltd.	50.32 (1.07%)	—	228.23 (4.85%)
5.	Karnataka Bank Ltd.	6.89 (0.23%)	—	28.79 (0.95%)
6.	Bank of America	—	—	—
7.	Development Credit Bank Ltd.	2.34 (0.11%)	—	6.35 (0.30%)
8.	HDFC Bank Ltd.	17.74 (0.37%)	—	401.76 (7.14%)
9.	Bank of Punjab Ltd.	13.87 (0.91%)	—	51.66 (3.37%)
10.	Centurion Bank Ltd.	47.28 (2.24%)	—	173.13 (8.20%)
11.	IndusInd Bank Ltd.	9.13 (.021%)	—	103.51 (2.37%)
12.	Nedungadi Bank Ltd.@@	5.93 (0.59%)	—	52.06 (5.22%)

@ Excluding data pertaining to ICICI Ltd. (since merged with the bank).

@@ The Bank was put on moratorium with effect from 2/11/2002.

\* Since merged with ICICI Bank Ltd. during the year 2000-01.

According to RBI, the above figures are reported by the Banks in Offsite Monitoring Returns for the relevant period

5.4 The succeeding paragraphs give details of the cooperative banks and the commercial banks regarding the irregularities committed by them in the banking transactions relating to capital market/stock brokers:

## **2. COOPERATIVE BANKS**

### **(a) Madhavpura Mercantile Co-operative Bank Ltd.**

#### **Introduction**

5.5 The Madhavpura Mercantile Co-op. Bank Ltd., (MMCB), Ahmedabad was registered under Gujarat State Co-op. Societies Act, 1961 and commenced Banking business on 19.10.1968. The Bank was issued a licence by RBI in 1994 to carry on Banking business. It became a scheduled Bank in April, 1996. MMCB is governed by Multi-State Co-op. Societies Act, 1984 with regard to organizational and management matters and by Banking Regulation Act, 1949 with regard to Banking and financial operations. Its operations are confined to Gujarat and Maharashtra States. It has a network of 28 branches—23 in Ahmedabad, one each in Baroda, Surat and Rajkot and two in Maharashtra i.e. Mumbai, Vashi-Navi Mumbai. The deposits and advances of the Bank stood at Rs. 1262.37 crore and Rs. 1717.36 crore, respectively, as on 31.3.2001. Till 13.3.2001 the affairs of the Bank were managed by an elected Board of Directors, which comprised eleven directors headed by Shri Rameshbhai Nandlal Parikh (Chairman) and Shri Devandra B. Pandya was the Chief Executive Officer since June 1969. The Board of Directors was superseded on 14.3.2001 at the instance of Reserve Bank of India to secure proper management and an Administrator was appointed. At present it is working under an arrangement evolved under the aegis of Central Registrar of Co-op. Societies who has appointed seven Administrators to manage the affairs of the Bank.

#### **Genesis of Crisis**

5.6 On 9/3/2001 there was a sudden rush of depositors at the Bank's Ahmedabad branches for withdrawal of their deposits which increased steadily up to 12.3.2001 and was caused by strong rumours that the Bank had extended guarantees to Shri Ketan Parekh, a leading stock broker at Mumbai, who had suffered huge losses in his share dealings. An Officer from Urban Banks Department of RBI at Ahmedabad was deputed to the Bank's head office to ascertain the factual position and also whether the Bank had any account in the name of the said broker Shri Ketan Parekh, if so the extent of financing. The Bank had denied in writing that it had any account of Ketan Parekh. It failed to furnish to the RBI, the trial balances as at the close of business of March 08 and 09, 2001 by 12.3.2001 (March 10 and 11 being holidays). Meanwhile, the Bank went on meeting the heavy demand by depositors by extending its working hours until the morning of 13.3.2001 when it suddenly closed down all its branches, ostensibly as it was no longer in a position to cope with the run. The Bank closed its shutters on 13.3.2001 onwards without giving any notice. This triggered a run on the deposits of several cooperative Banks, not only in Ahmedabad but also in other towns of Gujarat. Meanwhile, both the Chairman and the Managing Director of the Bank disappeared from the scene and were not contactable.

#### **Nature of Irregularities**

5.7 The Bank's Head Office and branches remained closed with effect from 13.3.2001 to 16.3.2001. The Chairman and the Managing Director resurfaced on 15.3.2001 and with the

persuasion of Reserve Bank and assistance of Government of Gujarat, the Bank opened its branches on 16.3.2001. A quick scrutiny was taken up with reference to the Bank's position as on 16.3.2001 as to the circumstances leading to the run on the Bank and the present financial position.

### **Financial Position**

5.8 The financial position (trial balance) of the Bank as on 31.3.2001 is given at Appendix-IV.

### **Salient Features of Scrutiny**

5.9 The snap scrutiny by RBI of books of the Bank at Ahmedabad and Mumbai has revealed following irregularities in the working of the Bank:

- (i) Since October 2000, there was steep increase in advances without corresponding increase in deposits. The steep increase in advances was mainly due to Bank's increasing exposure to certain share brokers. The urban co-operative Banks are prohibited by RBI regulations from making any loans to share brokers/share broking firms.
- (ii) The findings of the last statutory inspection of MNCB conducted with reference to its financial position as on 31.3.1999 did not reveal gross violation of lending norms. The irregularities were of rectifiable nature and did not warrant any harsh action against the Bank.
- (iii) Of the advances outstanding at Rs.1594.17 crore (as on 16.3.2001), a sum of Rs. 1082.22 crore constituting 68% of the advances were in the nature of unsecured advances, granted mainly to 21 borrowal accounts belonging to or related to stock brokers. At least 10 such accounts indicated linkages with Shri Ketan Parekh a leading stock broker with an exposure of Rs.843.57 crore i.e 77.9% of total advances to share brokers.
- (iv) A scrutiny of the advances portfolio of the Bank revealed grave irregularities. In several cases the balances outstanding in the borrowal accounts were far beyond the sanctioned limits—the gap ranged between 100% to 400%.
- (v) The wide divergence between the sanctioned limits and outstanding depicts unauthorized overdrawals which were allowed as per oral instructions of the Chairman and not confirmed subsequently.
- (vi) The loans to stock broking companies were unsecured and much beyond permissible limit of Rs.50000/- per borrower. The details of credit limits sanctioned and outstanding are indicated in the Appendix-V.
- (vii) The purpose for which such advances were given was indicated as 'loans against Fixed Assets' primarily with a view to camouflage its lending to share brokers which is prohibited by RBI.
- (viii) The centre of activity was its Mandvi branch Mumbai. High value Pay Orders were issued by debit to the unsecured limits beyond exposure norms of Ketan Parekh related accounts which were got credited ostensibly in the accounts of Ketan Parekh group of companies (aggregating Rs.4626.19 crore) maintained at the Fort (Mumbai) area branches of Bank of India and Global Trust Bank Ltd.

- (ix) The Board did not follow RBI guidelines relating to review of large borrowal accounts. The Board had sanctioned certain limits to various parties without proper credit appraisal and post-disbursement supervision was ineffective.
- (x) The Bank had been resorting to large borrowing through Call Money Market for the purpose of lending to these big borrowal accounts. The exposure of the Bank to call money market as on 16/3/2001 aggregated Rs. 197 crore.(Appendix-VI). It is observed that the Bank's borrowing was excessive in the call money market since last week of December, 2000.
- (xi) The Chairman of the Bank was one of the directors in M/s. Madhur Capital and Finance Limited, Ahmedabad, and M/s. Madhur Shares and Stocks Ltd. having current accounts at the Bank's Navrangpura Branch. He is also one of the directors in M/s. Madhur Food Products Ltd. which enjoys credit facility at the same branch to the extent of Rs.16.00 crore (much beyond the exposure norms) against hypothecation of goods and book debts. These companies also have current accounts in the Bank's Mandvi (Mumbai) branch. It was observed that large funds were transferred between these accounts in a routine manner. It was also observed that large amounts were withdrawn from the loan account of M/s. Madhur Food Products Ltd., for transfer to other accounts of the Chairman. These entries did not depict genuine trade transactions. Evidently large amounts lent by the Bank to Madhur Food Products Ltd. had been diverted to M/s. Madhur Shares and Stocks Ltd. and M/s Madhur Capital and Finance Ltd.
- (xii) The Bank had issued three Bank Guarantees against deposits of only Rs. 0.20 crore involving a sum of Rs. 1.50 crore to the Ahmedabad Stock Exchange on behalf of the Chairman's firm viz. M/s. Madhur Shares and Stock Ltd. All these Bank Guarantees were revoked on account of non-settlement by the party.
- (xiii) Unusually high amounts were transferred from the hypothecation account of Panther Fincap (Ketan Parekh group) to the Current account of Madhur Capital and Finance Pvt. Ltd., Navrangpura, Ahmedabad (the company belonging to the Bank's Chairman's group) through TTs during the period from 17.1.2001 to 28.2.2001 aggregating Rs.135 crore. Such transfer to the Chairman's company at Ahmedabad could be in consideration of unduly large credits extended to Ketan Parekh group at the Mandvi branch.
- (xiv) The Bank has blatantly violated RBI directive with respect to credit exposure for single borrower (20% of capital funds) or group of borrowers (50% of capital funds) by sanctioning credit limits much in excess of its credit exposure ceiling. The Bank's exposure to single borrower and group borrowers with capital funds at Rs. 27.52 crore worked out to Rs.5.50 crore and Rs. 13.75 crore respectively. As against that the Bank had disbursed amounts ranging from Rs.39.26 crore on February 28, 2001 in the account of M/s. Mukesh Babu Finance Services Ltd., to Rs. 154.57 crore on 1.3.2001 in the account of M/s. Panther Fincap P. Ltd. respectively.
- (xv) It had granted total credit facility of Rs.21.00 crore to the group (M/s. Madhur Food Products Ltd.) belonging to its Chairman in violation of RBI directive on Credit Exposure norms which was much more than the prescribed limit of 20% of its Capital Funds of Rs. 27.52 crore.
- (xvi) The Bank had defaulted in the maintenance of Statutory Liquidity Ratio (SLR) from 1.3.2001 onwards (latest position) as it had liquidated them to meet the other pressing needs of Call money borrowing and lending to share brokers.

- (xvii) The Bank's deposits as on 16.3.2001 aggregated Rs.1212.56 crore; of which institutional deposits, mostly from large number of cooperative Banks, aggregated to Rs. 590.13 crore forming 46.4% of the Bank's total deposits.
- (xviii) The Bank's Mandvi (Mumbai) and Navrangpura (Ahmedabad) branches were not functioning as per the established Banking practices and procedures.
- (xix) There appears to be deliberate intention on the part of Board of Directors, its Chairman and CEO, to flagrantly violate RBI guidelines, throw out sound Banking practices to make personal gain.
- (xx) The net erosion has been estimated at Rs. 1211.40 crore. The real or exchangeable value of the Bank's paid up share capital, reserves, etc worked out to negative i.e. (-) Rs. 1166.04 crore as on 16.03.2001 wiping out the paid up capital and reserves and also deposits to the extent of Rs.1166.04 crore forming 96.2% of the total deposits. The percentage of Net Erosion to Net Owned Funds worked out to 2670.3%.

5.10 Thus, the Bank was not complying with the provisions of Sections 11(1) and 22(3)(a) of the Banking Regulations Act, 1949 (As Applicable to Co-operative Societies). Further, its affairs were conducted in a manner detrimental to the interest of the depositors and thereby violative of provisions of Section 22(3) (b) of the Act *ibid*.

#### **Action taken by RBI**

5.11 In order to deal with the situation arising out of the collapse of MMCB, which was threatening the cooperative Banking sector in the State, the RBI took the following measures:

- (i) A directive by RBI under section 35 (A) of the Banking Regulation Act, 1949 (As Applicable to Cooperative Societies) (AACS), was imposed on MMCB on 13.3.2001, directing the Bank not to accept fresh deposits or give fresh loans and not to repay more than one thousand rupees to any single depositor. The ceiling was imposed taking into account the overall liquidity position of MMCB.
- (ii) Since MMCB was unable to meet its clearing obligations due to insufficient balance in its current account with RBI, Rule 11 of the Clearing House rules was invoked to unwind the clearing transactions and the Bank was compelled to return all the presentation made on it by the various member Banks and MMCB was also suspended from the Clearing house for a period of seven days, which has since been extended indefinitely, after review.
- (iii) A criminal complaint was lodged in the court of Chief Metropolitan Magistrate, Ahmedabad against the Bank, its Chairman and Managing Director on 14.3.2001 under Section 46 of the BRA, 1949 read with Section 58 (B) of the RBI Act, 1934 for having made false statements to RBI, with respect to their call money borrowings and also failing to meet its assurance for submitting the required information.
- (iv) With a view to secure proper management, at the instance of RBI on 14.3.2001, the Board of Directors of the Bank was superseded and an administrator was appointed by the Central Registrar of Co-operative Societies to manage the Bank's affairs. Shri S. Ramachandran, retired General Manager of Bank of Baroda, was appointed on 14.3.2001, as the Administrator and he took over charge in the forenoon on 19.3.2001. RBI in order to extend necessary support to the UCBs in the State of Gujarat, has also come out with the scheme to extend liquidity support subject to certain conditions. Three Civil Applications have been filed in the High Court of Gujarat,

Ahmedabad as public interest litigation. The Hon'ble Court in its order dated 2.5.2001, directed CBI (B.S. & FC) to conduct investigation against the deeds and misdeeds of Saravshri Ramesh Nandlal Parikh, ex-Chairman, Devendraprasad B. Pandya, CEO and MD (under suspension) and other officials involved in mismanagement. In pursuance of the Court's Orders, the criminal complaint lodged by the Administrator of MMCB on 21.3.2001 at Madhavpura Police Station, Ahmedabad against above mentioned officials was transferred to CBI, B.S & FC, Mumbai, for investigation and an FIR has been registered with Special Police Establishment B.S & FC/CBI/Mumbai branch on 18.5.2001. On 1.6.2001, charge sheet in the case has been filed against Ketan.V.Parekh, Kirtikimar Parekh, Kartik.K.Parekh, Davendra Pandya, Ramesh Parekh and J.B.Pandya u/s 120-B,420,467,468 and 471 of IPC.

The Honourable High Court of Gujarat at Ahmedabad in their Order dated 3.5.2001 in the Special Civil Application No.2617 of 2001 with Special Civil Application No. 2628 and 2633 of 2001, directed that for some extreme hardship cases for withdrawal from small depositors like widows, pensioners and like who need money for urgent necessities like medical treatment, marriage or expenditure for their livelihood, withdrawal to depositors are to be allowed by the Administrator of MMCB after obtaining due approval of Reserve Bank of India. Accordingly, withdrawal from accounts of depositors belonging to these categories of depositors is being permitted/approved by Reserve Bank of India.

5.12 In view of Urban Cooperative Banks being repositories of the deposits of small and middle income groups and not having the expertise to deal in a highly volatile stock market, the Reserve Bank of India in addition to its earlier guidelines prohibiting loans to individuals against shares, decided to prohibit these Banks from granting any financial assistance against security of shares and debentures effective from 19.4.2001.

The salient features of the instructions are as under:

- (i) Urban Cooperative Banks should not entertain any fresh proposals for lending directly or indirectly against security of shares either to individuals/stock brokers or to any other entity, further urban cooperative Banks should not grant any advance for financing Initial Public Offerings (IPOs).
- (ii) Urban Cooperative Banks should take immediate steps to recall advances to stock brokers or direct investment made in shares which were not permissible activities and to dispose off such investments forthwith.
- (iii) The advances granted to individuals against security of stock/debentures up to the hitherto permissible limit (i.e. Rs. 10 lakh/Rs.20 lakh against physical scrips/demat shares) should be repaid by the borrowers on or before the contracted dates. Such facilities should under no circumstances be renewed thereafter.

5.13 The Committee took oral evidence of the representative of the MMCB including its former officials namely, Shri Rameshchandra Nandlal Parikh, former Chairman, Shri Devendra Pandya, former Managing Director and Shri Jagdish B. Pandiya, former Branch Manager, Mandvi Branch of MMCB on 7.1.2002.

5.14 During the deposition, the present administrator of MMCB admitted that the loans given by the Bank to its former Chairman were unsecured loans, which was in violation of the regulations. He further confirmed that on 1.03.2001, the Bank had advanced loan of

Rs. 154.37 crore to M/s. Panther Fincap Private Ltd., a Ketan Parekh entity against an exposure limit of Rs.5.5 crore. Further, the KP entities were advanced loans of Rs.888 crore against the total sanctioned limit of Rs. 235 crore. It was also accepted by the present representative of MMCB that the advances were given to KP entities by the Mandvi Branch of the Bank on telephone instructions of the then Chairman.

5.15 According to the former Chairman of the Bank, the Board and the Chairman were sanctioning the loans according to the rules and the reasons for failure of the MMCB was due to the mistakes committed by the execution part and that all the money granted to KP group were in violation of the Board's decision. He denied that the Chairman or the Board of MMCB were aware of the advances of Rs. 888 crore to the KP Group.

5.16 The former Managing Director of the Bank, however, contradicted the above statements of the former Chairman and stated that everyone including the Board and the Chairman were aware of the unsecured advances given to the KP Group for the alleged purpose of broker business in the Capital Market which itself was against the RBI guidelines. He stated that there was no system of review of the large accounts by the Board. The reasons that such amounts did not reflect in the inspection of the RBI was that such amounts were shown as credit balance. According to him, the Mumbai Branch of the Bank was authorised to borrow call money from the market without the knowledge of Head Office and that there was no specific policy of the RBI in this regard. He submitted that advances to the tune of Rs. 888 crore were given to the KP entities by the Mumbai Stock Exchange Branch of the Bank on the instruction of the then Chairman and there was no Board sanction to enhance it from Rs. 180 crore to Rs. 888 crore. According to the present CEO of the MMCB, such increase of advances started from October, 2000 and all these transactions in excess of the sanctioned limits were done over a period of 6 months.

5.17 The former Branch Manager of the Mandvi Branch, Mumbai (Shri Jagdish Pandya) submitted that he was allowing excess drawing to KP companies and borrowing call money from market on the oral instructions over telephone from the then Chairman & Managing Director of the Bank. In this regard, he stated that:

"It is a regular practice and it is done on the phone only. All reports of overdrawn accounts are sent to the Head office only through the Chairman and the MD. In respect of whatever overdrawn accounts, we send our statement to them and on telephone, my office and I also inform him that these are the overdrawn accounts."

5.18 This fact was admitted by the former MD of the Bank also. The former Chairman, however, denied about ever giving the said oral instructions. The Committee were also apprised by him that there was only one auditor in the Bank who was doing both statutory and internal audit and there never was any adverse audit report.

5.19 On its being pointed out by the Committee that when nothing was wrong then why the Bank collapsed, the former Managing Director stated "I must control the system. But I failed it".

5.20 To the submission of the former Chairman that nothing was coming to the Board, the former MD contradicted it and submitted that internal inspection reports, statements, minutes etc. were always placed before the Board.

5.21 The present administrator of the Bank informed the Committee that according to existing provisions, a person can remain Chairman of a Cooperative Bank for 10—20 years. But now the Govt. of Gujarat is bringing legislation according to which a person cannot be appointed as Chairman for more than two terms.

5.22 Regarding the relationship with Ketan Parekh, the former Chairman submitted that he was not a relative of Ketan Parekh. He had only done brokerage for his company. The Committee were also apprised that Ketan Parekh was introduced by Shri Sirish Maniyar, who was the cousin of the former Chairman with the recommendation that he was a good party and to give him some facility.

5.23 In response to the question, the RBI have submitted that the periodicity of inspection of scheduled Urban Cooperative Banks other than weak UCBs was 'once in two years', prior to '1.6.2001. After the failure of MMCB, Ahmedabad, the periodicity was made 'once in a year' in respect of scheduled UCBs including weak UCBs w.e.f. 11.6.2001. The MMCB was inspected during September-October, 1999 with reference to its financial position as on 31.3.1999. No inspection was conducted during the year 2000 pertaining to the position as on 31.3.2000 as the periodicity was raised to once in a year only w.e.f. 11.6.2001.

5.24 On the periodicity of the inspection of the Bank, the former MD submitted that:—

"There was no periodical inspection either from the State Govt. or from the Central Registrar. Inspection was done only by the RBI and the auditors who were appointed by the State Govt. who were on the panel of the Central Registrar or the State Registrar..... The last inspection by RBI was in 1999".

5.25 Regarding his business activities, the former Chairman admitted that Madhur Capital & Finance Limited, Madhur Shares and Stocks Limited and Madhur Food Products Limited were his companies and the credit facility from MMCB was only in respect of Madhur Food Products and the other two companies had only current accounts with the Bank. He also admitted that there has been a large transfer of funds from the account of Madhur Food Products Limited to the accounts of the other two firms without any trade transactions taking place.

5.26 The present administrator of the Bank informed the Committee that against the sanctioned limit of Rs. 2 crore, an amount of Rs.19 crore was outstanding from Shri Shirish Maniyar, the cousin of the former Chairman. The amount of Rs. 2 crore was taken against shares and securities but in the balance sheet the entry was 'loans against fixed assets'.

5.27 The former Chairman also admitted to transfer of an amount of Rs.135 crore from 17.1.2001 to 28.2.2001 from the entities of KP M/s. Panther Fin. Cap Private Limited to the current account of M/s Madhur Capital & Finance Limited.

5.28 Regarding the pay orders of Rs.137 crore issued by the MMCB in favour of KP companies, the present management of MMCB informed the Committee that eight companies of Ketan Parekh had deposited clearing cheques of Rs. 146 crore against which the MMCB had issued the pay orders. However, these cheques were also returned by their Bankers. The Bank is required to make payment of Rs. 137 crore against pay orders to the Bank of India. This matter is pending with the Debt Recovery Tribunal and Ketan Parekh has also been asked by MMCB to deposit the amount for which the companies allegedly associated with KP had given promise.

5.29 The Committee were also informed by the former Branch Manager of Mandvi Branch that the former Chairman used to visit the Mandvi Branch for opening the accounts of KP companies by using his personal influence. This fact was denied by the former Chairman who stated that he had never visited that Branch.

5.30 Regarding filing of criminal complaints against the former officials of the Bank, the present CEO of the Bank stated as under:—

"We have filed one case before the police and thereafter it has been transferred to the Metropolitan Magistrate Court. The CBI is also inquiring into the matter. We have filed

individual cases against the Ex-Chairman and the Ex-MD and also against the Branch Manager under various sections, including section 120-B which provides that whenever the investigative agency finds that any other person is also a culprit, he may also be covered by the investigation. So it is now up to them.”

5.31 The former MD admitted before the Committee that he was fully aware that the money which was being advanced to Ketan Parekh companies to invest in share market was against the Banking regulations, but claimed helplessness because he did not have the job security and would have lost his job had he defied the Chairman’s directions.

5.32 Shri Devendra Pandya, Ex-MD informed the Committee that the former Chairman Shri Rameshchandra Parekh was earlier the Managing Director of the Bank right from its inception and knew everything about the Bank. He admitted that the Board was called at 3.00 A.M. in the night of 12.3.2001 (3.00 A.M. in the morning of 13.3.2001). The Chairman then told the staff not to take any action against him and he would bring Rs.100 crore in the morning and make the Bank operational. There were crores of rupees business dealings between the Chairman and Ketan Parekh entities and no one from the staff dared to stop him from indulging in corruption. Regarding the denial of the Chairman about giving instructions to the Branch Manager, Mandvi Branch, the Ex-MD clarified that such instructions were given over the four mobile phones maintained by the Chairman of the Bank.

5.33 He also submitted that the Chairman’s son was also involved for an amount of Rs. 46 crores. To a query of the Committee as to what was the commission of the Chairman when payments were made by the Bank to Ketan Parekh, the Ex-MD submitted that the Chairman did not take percentage but takes a share in the business by way of brokerage. The Ex-MD informed the Committee that the former Chairman used to sit in the Mandvi Branch, Mumbai of the Bank. Whenever phone calls were received from Ketan Parekh or Shirish Maniyar, he instructed the Branch Manager (Shri Jagdish Pandya) to move out of the cabin and thereafter instructed him to make payments of crores of Rupees in their favour. He submitted that the Bank was alright upto the end of October, 2000 and all the developments took place between November, 2000 to March 2001 but he denied that he had any prior knowledge of outstanding advances of Rs. 888 crores against the sanctioned limits of Rs.180 crore to KP entities and he came to know about it only on the 2.3.2001.

5.34 When the Committee pointed out that being the MD of the Bank, it was his responsibility also to detect these irregularities, he accepted the failure to do so. He admitted that he did not inform the RBI in regard to the irregularities committed by the Chairman of the Bank.

5.35 The Committee also heard the views of (Shri Jagdish Pandya) the Ex-Branch Manager of Mandvi Branch of the Bank. The Ex-Branch Manager submitted that the accounts of KP Group were opened in that Branch on the instructions of the former Chairman. To a pointed query of the Committee whether there was a nexus between the Ex-chairman & Ex-MD, the Ex-Branch Manager answered in affirmative. According to him the pay orders of Rs.137 crore to KP Group were issued by him on the instructions of the former Chairman. He also admitted that advances to the tune of Rs. 888 crore were made to KP Group on the instructions of the Ex-Chairman and Ex-MD. When asked by the Committee, Shri Ketan Parekh stated that certain amounts payable to MNCB from the borrowings have already been paid pursuant to the conditions of bail in the criminal complaint filed against him by MNCB.

5.36 The Committee took oral evidence of the Central Registrar of Cooperative Societies (CRCS); Registrar of Cooperative Societies, Gujarat and the representatives of the RBI .

5.37 During the evidence, the Central Registrar of Cooperative Societies stated that the Cooperative Banks expand their operations and Branches to more than one State then it is

registered as a Multi-State Cooperative Society. In 1985, the Central Government authorized the State Registrars of Cooperative Societies to exercise the powers of Central Registrar with regard to Multi-State Cooperative Society except two functions, namely, registration of Cooperative Society and the amendment of its bye-laws which have been retained by the Central Registrar. When something adverse come to its notice, the Central Registrar intervenes and takes appropriate action. The working of the Multi-state Societies and UCBs remain the day-to-day concern of the RCS of the respective States.

5.38 During evidence, Shri R.M. Joshi, RCS, Gujarat admitted that one Shri Jasubhai S. Patel had filed a complaint against MMCB in 1998 regarding the sanction of advances to entities related to former Chairman and his group companies. This complaint was forwarded by RBI to RCS, Gujarat on 26.10.1998 .

5.39 The Joint Registrar (Audit) of Cooperative Societies vide his letter dated 4.1.1999 replied to RBI that an enquiry had been conducted through the District Registrar of Cooperative Societies, Ahmedabad and "no substance was found" in any of the allegations. According to RCS, Gujarat, their reply to RBI was based on a previous investigation conducted by the District Registrar on the complaint of Jasubhai Patel which was earlier received by them . He could not give any reply to the query of the Committee as to why no further investigation was made on the report of the RBI.

5.40 The RBI representative commented on the issue as under:

"There was a complaint of April, 1998 from Shri Jasubhai Patel. There, he has given a number of instances of violation of Banking norms and abuse of authority on the part of Chairman. It was investigated by the RBI. There was a special investigation by RBI on the complaint made by Jasubhai Patel. We found that it was substantially correct and in a nutshell the finding was that there was gross abuse of authority because the loans and advances were made to Chairman, his relations and other Board members in gross violation of Banking norms. Since the Reserve Bank of India does not have power to take action against the management of the Bank and the power lies with the State Government, the matter was referred to the State Government. The Reserve Bank of India also pursued the matter with the Bank. I would like to clarify that it is not that the Reserve Bank of India did not take action. When the State Government writes back to the Reserve Bank of India that no substance was found in the complaint during the investigation, you may kindly appreciate our position."

5.41 According to him, as a follow up action, the RBI asked MMCB to recall the advances. Giving reasons for not superseding the Board of MMCB, the representative of RBI stated that RBI's approach is preventive and supersession is an extreme power, especially when their co-regulator i.e. RCS is stating that nothing was wrong. Further, since the Chairman of the Bank was more involved, it was not proper to punish the entire Board and even if RBI had requested the RCS to supersede the Board, their case would have been very weak.

5.42 Giving reasons for not conducting a proper inquiry against the Bank, the RCS, Gujarat submitted that RBI requested them to institute an enquiry under section 86 of the Gujarat Cooperative Societies Act, 1961 whereas the Bank does not fall under the said Act and further, section 86 is to determine whether the Board of Directors or officers have caused any loss to the Cooperative Society and if so, then an enquiry is to be instituted under section 93 for recovery of the said loss. In this case, apparently no loss was caused to the Bank.

5.43 On the justification put forward by RBI for not taking any action against the MMCB on the ground that the appropriate authority was the State Government, the Central Registrar stated that :

“It is not correct to say that the Reserve Bank of India has no authority. They have all powers under the Banking Regulation Act. Under the Multi-State Cooperative Societies Act also, the Reserve Bank of India has been given certain powers to enable them to take effective steps and control the Banking operations of such Banks because Banking operations are something very technical and only RBI can look after those functions effectively. So, under Section 48 of the Multi-State Cooperative Societies Act, if the RBI feels that something wrong is going on in a particular Bank and the management is not working properly, they have the powers to send a requisition to the Central Registrar to supersede that Board and appoint an Administrator and the Central Registrar is duty bound to supersede that Board if he receives a requisition from the Reserve Bank of India.”

5.44 Giving the sequence of events and the actions taken by the Central Registrar before and after the supersession of the Board on 14/15.3.2001, the Central Registrar submitted in detail as under :

“On the 13th of March, 2001, I got a call from the Secretary, Co-operation, Gujarat. He informed that something serious has happened in Madhavpura Bank. In fact, from October 2000 onwards, the CD Ratio—the Credit Deposit Ratio of the Bank, how much deposit it has got and how much credit it is advancing to the parties—in the month of September 2000, it was 76 percent, which was reasonable. It increased further in November, December, and in March it went up to 131 percent. That means, they have advanced something which is beyond their means, and that resulted into the liquidity crunch of the Bank. I got a message from the Secretary, Co-operation, Gujarat saying that there is a run on the Bank branches of this Bank and I got in touch with RBI. I talked to Mr. Mathur on telephone. He then sent a requisition to me for supersession of the Board and appointment of the Administrator. I got this requisition on the 15th of March and on the same day, I passed the supersession orders.

Now, under the provision of the Act, I, as the Central Registrar, can also supersede but there is a procedure for that. That procedure is lengthy. I have to issue a notice to the Board, they have to reply, and then I have to pass a final order. But in the case of RBI requisition, no such procedure is required. So, they sent me the requisition and I superseded the board of management of the Bank and appointed Administrator of the Bank.”

5.45 The Committee were subsequently informed by RBI that the CD Ratio of MMCB for the months of November and December, 2000 was 90.0 and 94.9 respectively and for the months of January and February, 2001 it was 104.8 and 109.4 respectively.

5.46 In reply to a query of the Committee as to why the RBI failed to notice the advances made by the Bank in excess of RBI norms from the monthly/quarterly reports received from MMCB, the RBI representative submitted that CD ratio was not being given in the reports then but now the RBI has prescribed its requirement in the report.

5.47 Responding to a question as to what action had been taken by the RCS, Gujarat State after 13.3.2001, the Registrar of Co-operative Societies, Gujarat stated that special audit was carried out for the year 1998-99 and 1999-2000 and audit for 2000-2001 was also done and they found that a number of irregularities had been committed by the auditors in their audit reports. Because of this default they were served with a notice for fixing the responsibilities for the loss

to the Bank. Those auditors were two Chartered Accountants namely, Shri Manubhai A. Panchal (1998-99) and Shri S.N. Valera (1999-2000) and a formal complaint was lodged in March, 2002 with the Institute of Chartered Accountants of India against them. He further informed the Committee that for Multi-State Co-operative Societies, audit is carried out by a panel of auditors who are Chartered Accountants, decided by the Central Registrar.

5.48 On being asked whether RBI proposes to issue any directives prohibiting the members of the Board of Directors from taking loans from the Banks for their personal use, RBI stated in the written reply that the Banking Regulation Act, 1949(As applicable to Co-operative Societies) does not prohibit urban co-operative Banks from granting secured advances to their directors/ their relatives or concerns in which they are interested. Section 20(1) of the Act provides as under:—

“20. Restrictions on loans and advances:

(1) No co-operative Bank shall—

(a) Make any loans or advances on the security of its own shares; or

(b) Grant unsecured loans or advances—

(i) to any of its directors; or

(ii) to firms or private companies in which any of its directors is interested as partner or managing agent or guarantor or to individuals in cases where any of its directors is a guarantor, or

(iii) to any company in which the chairman of the Board of directors of the co-operative Bank (where the appointment of a chairman is for a fixed term) is interested as its managing agent, or where there is no managing agent, as its chairman or managing director.

Provided that nothing in clause (b) shall apply to the grant of unsecured loans or advances—

(a) made by a co-operative Bank—

(i) against bills for supplies or services made or rendered to Government or bills of exchange arising out of *bonafide* commercial or trade transactions, or

(ii) in respect where of trust-receipts are furnished to the co-operative Banks;

(b) made by a primary co-operative Bank to any of its directors or to any other person within such limits and on such terms and conditions as may be approved by the Reserve Bank in this behalf.”

In pursuance to the above legal provision, the Reserve Bank of India had prescribed that the amount outstanding in respect of such unsecured advances to the directors and the concerns in which directors are interested and to the relatives of the directors and to the concerns in which the relatives are interested shall not at any time, taken together, exceed:

(a) Rs. 50,000/- or 10 per cent of the total of the time and demand liabilities, whichever is lower, in case where the total of the time and demand liabilities does not exceed Rs.1.00 crore.

- (b) Rs. 1.00 lakh, in cases where the total time and demand liabilities exceed Rs. 1.00 crore but less than Rs. 10.00 crore.
- (c) Rs. 2.00 lakh in cases where the total time and demand liabilities exceed Rs. 10.00 crore.”

In addition to the above, a ceiling of not exceeding 10 per cent of the Bank’s demand and time liabilities has been prescribed for the total loans or advances (both secured and unsecured or other financial accommodation) that could be granted by a UCB to all its directors and to the concerns in which its directors are interested as also to the relatives of the directors and to the concerns in which such relatives are interested.

5.49 Regarding the corrective measures suggested by RBI in view of the irregular transactions in the MMCB, the RBI representative submitted that :

“We have suggested to the Central Government to constitute an apex body for the supervision of the urban cooperative Banks where the representatives of the Central Government, State Government and various experts will be there. That proposal is under the consideration of the Government. We have sent a draft Bill also to the Government, and that matter is under consideration. After these irregular transactions in Madhavpura, we have taken a number of preventive steps. One is that the urban Banks cannot keep deposits with other Banks. We have given them time till June 2002 to unwind their transactions. We have increased the SLR proportion, the proportion of Government securities in the SLR requirement. We have done two major things. We are evolving ALM (Asset/Liability Management) guidelines so as to see that there is a proper balance in the assets and liabilities of these Banks. We have constituted a group comprising the representatives of urban Banks and our own staff. We have evolved guidelines. We have put them on our website. We are training the staff of the urban Banks in the asset/liability management. We are also evolving a rating system. These are some of the measures which will strengthen the urban Banking system.”

5.50 The Committee were informed that under the existing Multi State Co-operative Societies Act there are about five lakh co-operative societies in the country. Though co-operation is primarily a State subject, the Government of India is primarily concerned with the Multi State Co-operative Societies governed under the MSCS Act, 1984. Of the 311 MSCS that are functioning, 32 are Urban Co-operative Banks. The Central Registrar of Co-operative societies does not register these Multi State Urban Co-operative Banks which are governed under the concerned State Acts.

5.51 Under the Section 96 of the Multi State Co-operative Societies Act, the punishment for a member or officer willfully making a false return or furnishing false information has a maximum fine of Rs.200. Further, in the event of any fraudulent transaction taking place or mismanagement, there is ambiguity with regard to role of the Central Registrar of Co-operative Societies or the State Registrar or the RBI.

5.52 The Committee went through the recommendations made by the Jagdish Capoor Committee Report as well as the High Powered Committee constituted under Shri Madhav Rao and noticed that both the committees had advocated that duality of control in the case of the co-operative Banks was posing serious problems in their working and recommended that necessary legislative changes should be made to resolve this issue. The Madhav Rao Committee which had particularly been constituted on Urban Co-operative Banks had recommended that the only effective way to address the problem of dual control is to carry out amendments in the State Co-operative Societies Act, 1984 and also Banking Regulation Act, 1949 to clearly demarcate

the Banking related functions which are to be solely regulated by RBI and those related to the establishment of Co-operative Societies and their co-operative character which shall remain within the domain of the Registrar of Co-operative Societies of the concerned States. The Committee were informed that RBI has since accepted most of the recommendations. RBI has also informed that the issue relating to the amendments to the State Co-operative Societies Acts, as recommended by the High Powered Committee was recommended to the Government with a request to take up the matter with the concerned State Governments to promote necessary legislative amendments in this regard. In reply, Ministry of Finance, have advised that it may be possible to bring the co-operative Banks under the discipline of RBI's regulatory and supervisory regime by making suitable amendments in the Banking Regulation Act irrespective of provisions in the State Co-operative Societies Acts and the Government would like to consult the Ministry of Law on the subject and accordingly requested RBI to submit comprehensive proposals for amendments of Banking Regulation Act 1949.

5.53 In view of the request made by the Ministry of Finance, RBI has forwarded proposed amendments to Sections 5, 7(2), 11, 22, 30, 36(AC) and 45 of Banking Regulation Act to the Government of India.

5.54 The Committee note that although there do not appear to have been any serious violations by the Bank of the guidelines issued by RBI till 30.6.2000, there was thereafter a steep increase in advances without a corresponding increase in deposits. In fact, the CD ratio went up between October 2000 and March 2001 from 76 per cent to 131 per cent, which meant that the Bank was lending beyond its means. The steep increase in advances was mainly owing to the Bank improperly and illegitimately making vast sums available, under various guises, to certain stockbrokers, in particular entities controlled by Shri Ketan Parekh. That the exponential increase of advances to KP Group companies occurred when the market was falling shows that the nexus between the Bank and the broker was of long-standing. The Committee also note that at the Mandvi branch, Mumbai of the Bank, large Pay Orders were issued to the Ketan Parekh group of companies aggregating Rs. 4626.19 crore between 27.11.2000 and 9.3.2001. Of the advances outstanding at Rs 1594.17 crore (as on 16.3.2001) a sum of Rs. 1082.22 crore, constituting 68% of the advances, were in the nature of unsecured advances granted to 21 borrowal accounts belonging to stock brokers. Out of these, at least 10 accounts indicated linkages with Ketan Parekh, in whose case the exposure was Rs 943.57 crore i.e. 77.9% of total advances to share brokers.

5.55 MMCB was relying on the Call Money Market to meet with exigencies but on no occasions defaulted in its repayment obligations except on 7.3.2001 when its borrowings from Call Money market, attributed largely to the advances it had given to the Ketan Parekh and other broking entities in the form of Pay-Orders etc. were left unsecured. While the Ketan Parekh entities were able to avail of instant credit by discounting the MMCB Pay-Orders aggregating to Rs.137 crore from the Stock Exchange Branch of Bank of India, Mumbai, the entities enjoyed substantial sanctioned limits, MMCB failed to meet with its obligations at the Brihan Mumbai Clearing House when the said Pay-Orders were presented for settlement on 9/3/2001. The feasibility of the Bank's harnessing potential alternative means to satisfy its clearance obligations was nipped in the bud when RBI stepped in on 13.3.2001 and invoked Rule 11 barring MMCB from accessing the Clearing House in any manner with retrospective effect from 9.3.2001. The Committee are of the view that while the nexus between Chairman, MMCB and Chairman of KP group companies warrants further investigation by the agencies concerned, it is also necessary for RBI and SEBI to draw the right lessons from the regulatory point-of-view to put in place an integrated system of alerts which would piece together disparate signals from different elements of the market to generate special attention to any unusual activity anywhere in the system which might have a bearing on the integrity of the stock market.

5.56 The Committee take serious note that the Chairman and top executives of the Madhavpura Mercantile Co-operative Bank indulged in a series of irregularities flouting all prudent Banking norms and the guidelines laid down by the Reserve Bank of India. This resulted in a run on the Bank in March 2001 and triggered a run on the deposits of several co-operative Banks, not only in Ahmedabad but also in other towns of Gujarat. In view of its inability to meet the heavy demand of the depositors, MNCB closed down all its branches on 13.3.2001.

5.57 Other glaring irregularities pointed out by RBI in their special scrutiny undertaken after the exposure of the scam in March 2001 were that, in several cases, the balances outstanding in the borrowal accounts were far beyond sanctioned limits, the gap ranging between 100% and 400%. The wide deviation between sanctioned limits and outstandings reflected overdrawals which were allowed as per the oral instructions of the Chairman and these were not confirmed even subsequently. Loans to stockbroking companies were unsecured and much beyond permissible limits. The purpose for which such advances were given was indicated as "Loans against Fixed Assets" primarily with a view to camouflaging the Bank's lending to brokers in violation of RBI guidelines. Moreover, the Bank's Board violated RBI guidelines relating to the review of large borrowal accounts. Limits were sanctioned without proper credit appraisal and post-disbursement supervision was ineffective. Besides, the Bank had been resorting to large borrowings through the call money market for the purpose of lending to these big borrowal accounts. Between December 2000 and March 2001, the Bank's daily exposure to the Call Money Markets rose from Rs. 122 crore to a peak of Rs. 270 crore and stood at Rs. 197 crore on 21.3.2001.

5.58 During the RBI inspection conducted for the year 1999, it has been noticed that the standard of credit appraisal obtaining in the Bank was deficient. However, RBI did not take corrective action. The Bank violated RBI directives with respect to credit exposure, sanctioning credit limits much in excess of its credit exposure ceiling. It also defaulted in the maintenance of the Statutory Liquidity Ratio (SLR). Although RBI has said CD ratios were not required to be included in monthly/quarterly reports received from UCBs, the Committee are of the view that even in the absence of a specific provision for the calculation of CD ratios in the format of report submitted to RBI, discrepancies between credits and deposits in MNCB returns should have been evident from the face of the record.

5.59 The Committee take serious note of the fact that the then Chairman of the Bank was instrumental in getting huge amounts of loans sanctioned by the Bank in blatant violation of extant rules/guidelines either for his personal gain or for the benefit of his close relations. He misused his official position for his personal business interests by securing from the Bank credit facilities much beyond exposure norms for M/s Madhur Food Products Ltd., a company in which he was a Director. Large funds were transferred between different accounts belonging to the business concerns of the Chairman; for instance, amounts were withdrawn from the loan account of M/s Madhur Food Products and transferred to other accounts of the Chairman, that is, M/s Madhur Shares and Stocks Ltd. and M/s Madhur Capital and Finance Ltd. In the pursuit of his vested interests, the Chairman colluded with Ketan Parekh. For example, between 17.1.2001 and 28.2.2001, Rs. 135 crore were transferred from the hypothecation account of M/s Panther FinCap and Management Services Pvt Ltd—a company belonging to the Ketan Parekh Group to the current account of M/s Madhur Capital and Finance Pvt Ltd.—a company belonging to the Bank Chairman's group. This appears to have been done in consideration of unduly large credits extended by the Bank to the Ketan Parekh Group at its Mandvi branch, Mumbai, indicating a business nexus between the Chairman and Shri Ketan Parekh.

5.60 The Committee note that way back in 1998, one Shri Jasubhai S. Patel of Ahmedabad registered a complaint against MNCB regarding misuse of public monies and gross violation of rules/regulations etc., simultaneously but separately with the Registrar of Cooperative Societies,

Gujarat and RBI. RCS Gujarat conducted an inquiry through the District Registrar, Ahmedabad who gave MMCB a clean chit. However, after conducting its own investigation, RBI found that the Chairman of the Bank was indulging in all sorts of malpractices for personal gains. RBI also noted many other irregularities. Yet, although the RBI report was forwarded to RCS Gujarat for taking further action, RCS Gujarat merely reiterated the clean chit given earlier by the District Registrar. Thereafter, RBI did not pursue the matter further. Nor did RBI take up the matter, as it should have, with the Central Registrar of Co-operatives. The Committee are unable to accept the plea taken by RBI that they were helpless in the matter in view of the report received from the State Registrar.

5.61 The Committee question the role played by the State Registrar, who, instead of constituting a special audit, just forwarded the report received from the District Registrar and did not bother himself to investigate the veracity of the charges made. The Committee consider this a serious lapse on the part of the State Registrar. The Committee find that under the Act itself, the State Registrar was vested with wide powers and could have superseded the board. Consequent to the delegation of authority by the Central Registrar to the State Registrar, there should have been a mechanism in place for the Central Registrar to be informed of any unusual activity in the Bank.

5.62 The question of duality of control engaged the consideration of the Committee. This aspect is covered in detail under the chapter relating to RBI.

5.63 The Committee also note the dubious role played by the auditors who failed to point out serious irregularities while conducting audit for the year 1998-99 and 1999-2000. A formal complaint is reported to have been lodged in this regard by the RCS Gujarat with the Institute of Chartered Accountants of India in March, 2002. Even in the absence of the calculation of the CD ratio, discrepancy between credit to deposit were evident from the face of the records.

5.64 The Committee were informed that a criminal complaint was lodged by the RBI in the court of Chief Metropolitan Magistrate, Ahmedabad against the MMCB, its Chairman and Managing Director on 14.3.2001 under section 46 of the Banking Regulation Act 1949, read with section 58(B) of the Reserve Bank of India Act, 1934, for having made false statements to RBI with respect to call money borrowing and also failing to meet its assurance for submitting the required information. A criminal complaint had also been lodged by the Administrator of MMCB Ltd. with Madhavpura Police Station, Ahmedabad on 21.4.2001. Later, in terms of the order of the High Court of Gujarat, Ahmedabad dated 2.5.2001, CBI has been directed to investigate the deeds/misdeeds of the ex-Chairman and Managing Director and other officials involved in the mismanagement of the Bank. In pursuance of court orders, the case was transferred to CBI, Mumbai, and an FIR has been registered with Special Police Establishment, Mumbai Branch on 18.5.2001. On 1.6.2001, charge sheet in the case has been filed against Ketan.V.Parekh, Kartik.K. Parekh, Ramesh Parekh, Chairman, MMCB, Devendra B. Pandya, Managing Director, MMCB and Jagdish.B.Pandya, Branch Manager u/s 120-B,420,467,468 and 471 of IPC. The case is stated to be pending in the Court of the Chief Metropolitan Megistrate, Mumbai. The Committee desire that these cases be decided expeditiously.

5.65 The Committee note that in view of the serious irregularities committed by MMCB, a series of measures have been taken by RBI whereby UCBs have been prohibited from extending financial assistance against securities of shares and debentures. RBI has also prohibited UCBs from grant of advances from financing Initial Public Offerings (IPOs). RBI has also directed that steps be taken to recall all such advances to stock brokers. Whereas prior to 11.6.2001, pursuant to RBI directives, inspection of UCBs was effected once in two years, after that the periodicity will henceforth be once every year.

5.66 It will be seen that almost everything was being wrongly done in MMCB and almost everyone was involved. This case therefore deserve severest action. The Committee recommend the following :—

- (i) The Committee is of the opinion that in the gross irregularities committed in the functioning of the MMCB, everyone was involved. The Committee believe that all those involved must be dealt with severely and expeditiously. The Committee recommend that RBI, State Registrar of Co-operative Societies and Central Registrar of Co-operative Societies should fix responsibilities for wrong doings and proceed expeditiously against all those who are found involved . Had such misdeeds not been committed, the fabric of co-operative Banking system could not have been affected to this extent.
- (ii) The Ministry of Finance must give a serious thought to the problem of duality of control in the case of co-operative banks which in fact is not only resulting in cross directives adversely affecting the working of the co-operative banks but also since most of the State Registrars are not exercising proper control and surveillance over these banks, it is noticed that the co-operative banks often flout rules with a sense of total impunity without the fear of any kind of accountability. The Committee therefore are inclined to agree with the recommendations made by the High Powered Committee and desire that the bank-related functions of the co-operative banks should be brought fully under the purview of Banking Regulation Act, 1949, so as to bring a clear demarcation of areas of activities of cooperative banks which will fall under the domain of RBI *vis-a-vis* the Registrar of Co-operative Societies. The legislative proposals submitted by the RBI to the Ministry of Finance as well as the proposal regarding setting up a separate apex body for regulating the entire urban co-operative sector therefore, merits early consideration.
- (iii) In order to prevent irregularities of the type surfaced in the case of some of the co-operative Banks which were examined by the Committee they are of the view that full ban on granting of loans and advances to the directors and their relatives in concerns in which they are interested needs to be imposed. Appropriate legal procedures may be initiated to ensure that there is no conflict of interest in the grant of loans and advances to the directors and their relatives in the concerns in which they are interested.
- (iv) The Committee recommend that stringent laws be put in place to deal with fraudulent transaction like the ones that have come to light in relation to the affairs of MMCB and conduct of it Chairman and other senior functionaries. The laws must ensure that those guilty be brought to book expeditiously and disgorge their ill-gotten gains through confiscation of property and other appropriate measures.
- (v) Penalties under the Banking Regulation Act, 1949 for false return/information must be enhanced to serve as a deterrent.

(b) City Co-operative Bank Ltd., Lucknow

**Brief History of the Bank**

5.67 The City Co-operative Bank Ltd. Lucknow was registered on 22.8.1994 under the UP Co-operative Societies Act, 1965 and was issued a licence to carry on Banking business on 21.1.1995. The area of operation was earlier confined to the Municipal limits of Lucknow but was subsequently extended to cover the contiguous districts of Unnao, Rae Bareli and Barabanki.

The Bank has 4 branches including the main branch. Its deposits and advances stood at Rs. 66.48 crore and Rs. 32.22 crore respectively, as on 31.3.2001. The Bank is permitted to conduct normal Banking business and at present it is prohibited under an RBI Direction from accepting fresh deposits and making fresh advances. The Bank was not authorized to deal in foreign exchange including acceptance of NRE/NRO deposits. The Bank was functioning under an elected Board of Directors, which took over from the previous Board on 30.11.1999. The Bank had no investment policy. It now transpires that Shri Anand Krishna Johari who was on the Board of the Bank since 1996, was taking investment decisions and making investments in his companies contrary to RBI guidelines.

5.68 On 20.3.2001, there was heavy rush for withdrawal of deposits in all the four branches of the City Co-operative Bank Ltd., Lucknow triggered off following a news report which appeared in local daily 'Dainik Jagran' at Lucknow that there have been defaults by one Shri Anand Krishna Johari, promoter of M/s. Century Consultants Ltd., a stock broking firm and a director on the Board of the Bank who was entrusted by the Bank for management of its investment portfolio. The matter was investigated by the Lucknow Regional Office of Reserve Bank of India.

5.69 Investigations have revealed that the Bank had opened deposit accounts in respect of four front companies of the promoter of M/s. Century Consultants Ltd. (A.K. Johari Group) viz. Cyberspace Infosys Ltd., Kamal Infosys Ltd., Kamal Infosys Integrated Technologies Pvt. Ltd., and Country Informtech Services Pvt. Ltd. whose accounts were opened without observing the applicable norms. Shri Anand Krishna Johari's explanation in this regard during the course of evidence was not found satisfactory.

5.70 Between 5.3.2001 and 15.3.2001, the Bank's funds to the extent of Rs. 6.50 crore were utilized for investments in the bonds of Shri Johari's concern viz. Cyberspace Infosys Ltd. against RBI instructions which prohibits investment in the equity of such companies.

5.71 As on 22.3.2001 the Bank's outstanding investments as per its books of account was Rs. 3082.88 lakh. However, the Bank had in its possession scrips/certificates worth only Rs. 942.32 lakh. Documentary evidence in respect of remaining investment amounting to Rs. 2140.56 lakh was not available indicating that it is only a book entry and the money has been misutilised by Shri A.K. Johari.

5.72 The total loans and advances of the Bank aggregated Rs. 3138.76 lakh. The Bank had not framed any loan policy. There was no system of credit appraisal. No loan committee was formed and the credit decisions were mostly taken by Shri A.K. Johari as in the case of investments. The Bank had not followed the committee approach in sanction of loan proposals. The advances were generally disbursed on the basis of disbursement orders given by the Secretary-cum-Chief Executive Officer.

5.73 The Bank had invested funds to the extent of Rs.15.68 crore in term deposits with Bombay Mercantile Co-operative Bank Ltd., U.P. Co-operative Bank and Lucknow Co-operative Bank in fixed deposits and receipts aggregating Rs.2.62 crore could not be produced for verification. These were encashed but not accounted for.

5.74 Advances against shares in physical form were granted in several cases much in excess of the ceiling of Rs.10.00 lakh per individual, prescribed by Reserve Bank of India. As against the requirement of sanctioning a running limit and allowing operations in accordance with the drawing power arrived at on the basis of the market value of shares at periodical intervals,

advances against shares were sanctioned by way of term loans. Almost the entire portfolio (advances against shares) of Rs. 1.53 crore had turned into Non Performing Assets (NPAs).

5.75 The Bank had violated RBI directives on unsecured advances by sanctioning limits in excess of Rs. 50,000 in a number of cases. During the period January-March 2001, the Bank had sanctioned large advances to the tune of Rs. 5.88 crore to 15 borrowers without the backing of any tangible security, in violation of directives on maximum limit on unsecured advances.

These advances were treated as fictitious in view of the under noted features observed in all these accounts :—

- (i) Loan applications were blank
- (ii) Documents did not bear the signature of the borrowers
- (iii) Sanction/disbursement notes were not signed by any official
- (iv) Advances were unsecured and not backed by any collaterals
- (v) Funds were released by way of demand draft without ensuring end use of funds lent.

5.76 The Secretary of the Bank had approved purchase of cheques amounting to Rs. 1.71 crore from two front companies viz. Kamal Infosys and Country Informtech Pvt. Ltd. belonging to Shri A.K. Johari, Director, during the first fortnight of March 2001 which were either not presented for collection or bounced. This facility also became NPA.

5.77 In several cases, the Bank had violated the guidelines of RBI on credit exposure of individual exposure norm of 20% of its capital funds and group exposure norm of 50% of its capital funds.

5.78 The liquidity position of the Bank was extremely unsatisfactory. As on the date of the present scrutiny i.e. 22.3.2001, the deposit liability of the Bank stood at Rs. 65.9 crore against which the Bank held liquid assets at Rs. 8.14 crore which formed only 12.3% of its total deposits.

5.79 There was heavy reliance on institutional deposits. Of the total deposits aggregating Rs. 65.9 crore, institutional deposits stood at Rs. 29.44 crore forming 44.7% of the total deposits.

5.80 The Bank had circumvented the Cash Reserve Ratio (CRR) prescription as laid down under Section 18 of the Banking Regulation Act, 1949. It had adopted a novel way of inflating its balances with notified /eligible Banks in its own books by booking fictitious debit entries in the accounts of the Banks in its books of account and crediting Payment Order account. Pay Orders were purportedly issued on the 4 Banks with whom the City Co-operative Bank Ltd. had current accounts. The Bank-wise inflated position of balances on account of fictitious pay orders as on the date of scrutiny was as under :—

Name of the Bank	Rupees in lakh
(i) State Bank of Hyderabad, Sapru Marg	34.00
(ii) UP Coop. Bank Ltd., Vidhan Sabha Marg	40.00
(iii) UP Coop. Bank Ltd., Main Branch	54.00
(iv) Dena Bank, Hazratganj	30.00
Total	158.00

These Pay Orders were raised on these Banks on the days the City Co-operative Bank Ltd. had shortfall in the CRR and the entries were reversed on the days it complied with CRR requirements.

There was no system of concurrent audit although the level of Bank's deposits portfolio had exceeded the stipulated level of Rs. 50 crore.

5.81 The Bank had also violated Reserve Bank of India guidelines on income recognition, asset classification and provisioning. Unrealised interest on NPA accounts which was taken to Profit and Loss Account, had not been reversed.

5.82 The Bank's funds to the tune of Rs. 3230.22 lakh were systematically siphoned off through companies of Shri A.K. Johari, a Director in the Bank, in the following manner :—

		Rs. in Lakhs
(i)	Cheque Purchase (Clean facility)	171.35
(ii)	Investments in which scrips not Available (i.e. fictitious)	2140.56
(iii)	Clean Overdrafts to M/s Kamal Infosys	42.83
(iv)	Fictitious clean Advances	588.25
(v)	Fixed Deposit Receipts not traced	262.00
(vi)	Funds withdrawn through S.B. A/c	25.00
Total		3230.22

5.83 Net worth of the Bank has been assessed as negative at (-) Rs. 32.86 crore after making requisite adjustments which was mainly due to large scale siphoning off funds by Shri A.K. Johari, one of the Directors of the Bank. The Bank, therefore, does not have adequate assets to meet its liabilities and thus does not comply with the provisions of Section 22(3)(a) and 22(3)(b) of the Banking Regulation Act, 1949. Further the Bank does not comply with the requirement of minimum capital prescribed in terms of the provision of Section 11(1) of the Banking Regulation Act, 1949.

5.84 With a view to prevent preferential payment to depositors and to contain the run, a Directive by RBI under section 35(A) of the Banking Regulation Act, 1949, was imposed on 22.3.2001 directing the Bank not to accept fresh deposits or give fresh loans and not to repay more than one thousand rupees to any single depositor.

5.85 The Registrar of Co-operative Societies, Uttar Pradesh had been requested on 3.4.2001 to supersede the Board of management of the captioned Bank and to appoint an Administrator for securing proper management by invoking the provisions of Sub-section, (iii) of Section 90(B) of the UP Co-operative Societies Act, 1965. Accordingly, the Registrar of Co-operative Societies issued an order on 9.4.2001 superseding the Board and appointing the District Magistrate Lucknow as the Administrator of the Bank.

5.86 In view of the serious irregularities in the functioning of the Bank as revealed during the scrutiny of books of accounts, a criminal complaint was filed by the Reserve Bank against the Chairman, Directors and Chief Executive Officer of the Bank in the Court of Judicial Magistrate, Lucknow on 3.4.2001.

5.87 The last Inspection Report of the RBI dated 10.6.1999 on City Cooperative Bank Ltd., Lucknow conducted (prior to the special scrutiny in March, 2001) with reference to the financial position of the Bank as on 31.3.1999, also pointed out the following shortcomings:—

- (i) The Institutional deposits held by the Bank (44.3%) were on the high side.
- (ii) The C.D. ratio of the Bank at 22.16% was very low.
- (iii) The Bank had not invested 10% of Net Demand & Time Liabilities in Government and other securities. Also Bank's investments in non-SLR securities was far in excess of ceiling of 10% of deposits.
- (iv) The Bank had not adopted any loan policy/procedure.
- (v) The credit appraisal system was not satisfactory.
- (vi) Working of the Board of Directors was not satisfactory since it was not reviewing periodically important aspects.
- (vii) The Bank did not have any system of valuation etc. of the investment made by it.
- (viii) The Bank had prepared a draft loan policy but on prima facie perusal of the same, it was observed that the same was not up to the mark and comprehensive since RBI guidelines on the subject were not kept while the loan policy was drafted and also the draft policy had not been discussed/deliberated in any board meeting.
- (ix) The loan committee had been constituted but it was observed that the loans and advances were being sanctioned by it without critical examination of the credit proposals.
- (x) The post-disbursement supervision of the credit left much scope for improvement and the end use of funds was not being ensured.
- (xi) There was no system of periodical inspection of units/firms financed by the Bank.

5.88 Further, it was also observed that some of the deficiencies pointed out in the previous inspection report viz. framing of loan policy, appraisal of credit proposals, low level of C.D. ratio etc. were not rectified by the Bank so far.

5.89 Similarly, many irregularities were pointed by the auditors of the State Co-operative Department in the audit inspection of the Bank during the years 1997-98, 1998-99 and 1999-2000. Some of the serious irregularities as pointed by the auditors in respect of 1999-2000 were as follows:—

- (i) At the time of opening of new accounts, the RBI guidelines like satisfactory identity, complete address etc. of the parties were not followed.
- (ii) Large payments through cheques or bills were made without following required formalities in violation of the RBI guidelines. The details of such payments were also not maintained.
- (iii) The loans against shares was 24.20 per cent of the total loans which was in violation of the RBI guidelines.

5.90 It was further pointed out in the audit report that the RBI guidelines in 1994 prescribed a comprehensive direction to be followed by the Banks regarding the concurrent audit. These directions were violated by the Bank which was against the interests of the Bank. In a number of cases the documents desired by the auditors were not made available to them. As a result, the auditors could not give their comments on such matters.

5.91 The RBI informed the committee subsequently in written replies that they had filed criminal proceedings against the ex-officials and Board members of the Bank under Section 58 (B)/58 (C) of RBI Act 1934 and Section 46 of the Banking Regulations Act, 1949. The Committee were also informed that RBI, Lucknow had filed a criminal complaint on 3.4.2001 in the Court of Chief Judicial Magistrate, Lucknow against the City Co-operative Bank Ltd. Lucknow, its Chairman and 11 other Directors and the Secretary-cum-Chief Executive Officer of the Bank on the following grounds;

- (i) The Bank had shown its investment in its statements of Liabilities and Assets as on 22.3.2001 at Rs. 30.31 crore whereas the scripts produced for verification were for Rs. 9.42 crore only.
- (ii) The Bank had borrowings to the tune of Rs.10.36 crore but in its records this amount was shown under "other liabilities" instead of under "borrowings".
- (iii) Urban co-operative Banks are also prohibited from investing their surplus funds other than in the public sector bonds, equity of all-India financial institutions, units of UTI. Contrary to this, the Bank had invested Rs. 6.50 crore in Cyberspace Infosys Ltd. Further, the Bank's investment in non-SLR instruments exceeded the prescribed limit of 10% of their deposits.

RBI also informed the Committee that CBI Lucknow/SPE has filed charge sheet in one case on 13.11.2001 against Shri Gorakh Nath Srivastava, Shri Anand Krishna Johari, Shri Anand Mohan Johari and Shri Surendra Nath Mishra under sections 120B, 420,467,468 and 471 of IPC.

5.92 The City Co-operative Bank Ltd., Lucknow has filed two Criminal cases with Police Authorities against Shri Gorakh Nath Srivastava, the ex-Secretary of the Bank and Shri Anand Krishna Johari, then Director of the Bank, for siphoning off Bank's funds to the tune of Rs. 30.00 crore (approximately) in the form of fictitious investments and benami loans.

5.93 The Committee took oral evidence of the representatives of the City Cooperative Bank Ltd. along with its former officials namely, Shri Gorakh N. Srivastava, former Secretary/CEO and Shri Anand Krishna Johari, former Director and Shri Arvind Johari, brother of Shri Anand Krishna Johari at their sitting held on 9/4/2002. During the evidence the views of Shri Jeevesh Nandan, DM, Lucknow and Administrator of the Bank and Shri R.K. Tiwari, Registrar of Cooperative Societies, U.P. were also heard by the Committee.

5.94 Giving a brief history of the Bank Shri Jeevesh Nandan, DM (Lucknow) and the present Administrator of the Bank submitted that the Bank was promoted by 15 persons and Shri Gorakh N. Srivastava was one of the promoters who was later appointed as Secretary in the first general meeting of the Bank. In the meeting of the Board of Directors of the Bank on 31.10.1998, Shri Anand Krishna Johari, Director was given all the powers by the Board relating to buying/selling of investments and keeping them in his custody on behalf of the Bank. He was made Director (Finance) on 6.12.1999. In addition to what has been reported by RBI, the Committee was also informed that two FIRs dated 2.5.2001 & 18.5.2001 were also lodged against the erstwhile Director Shri Anand Krishna Johari and erstwhile Secretary Shri Gorakh N. Srivastava for siphoning off funds from the Bank in the form of fake investments, loans, advancements etc. to the tune of Rs.17.42 crores. The second FIR was for siphoning off funds in the form of cheque purchase for Rs.1.71 crore. The two cases were subsequently taken over by the CBI in July, 2001 which is conducting investigations and in one of the cases, they have already filed a chargesheet. In addition to this, departmental proceedings against Shri Gorakh N. Srivastava have also been launched. Till date, the Bank had lost around Rs.36 crore.

5.95 Shri R.K. Tiwari, RCS, UP, supplementing the aforesaid comments of the Administrator stated that on requisition of the RBI, the Board of the Bank was superseded and orders were issued under Section 65 of the UP Cooperative Societies Act asking the MD of the UP Cooperative Bank to conduct an enquiry into the alleged irregularities.

5.96 Regarding the role played by the Co-operative Department on the irregularities committed in the Bank, the RCS, UP stated that that the inspection of the Bank was not done before by the officials of the State Department and their role is confined to see that co-operative laws are being properly followed and they do not have the expertise on Banking and it is in the domain of the RBI.

5.97 On the query of the Committee as to what steps have been taken/proposed to be taken to prevent these kinds of irregularities, the RCS, UP submitted that they have proposed many remedies. According to him, if the audit is conducted in time which otherwise is normally delayed, and in depth, then such irregularities can be curbed to some extent. It has, therefore, been decided to take the expertise of the Chartered Accountants for conducting audit of all co-operative Banks. He submitted that the managing directors of all Banks have been asked to ensure that the balance sheets of the Banks are ready by 30th April and a copy of that may be made available to RBI as well as the Co-operative Department and the accountability for any delay is also going to be fixed. He stated that the dates for carrying out the audit of each Bank has been fixed and instructions in this regard have been widely circulated on 5.3.2002. According to him, till now, the inspection instructions were different and could not be even monitored as to see whether audit was done on time or not. However, as per the new instructions, each UCB has been earmarked to a concerned officer and the date of inspection of each Bank has been fixed and an exhaustive list of points for such inspections has been enumerated. Under the new instructions, reports are to be submitted to the office of the Registrar for further monitoring.

5.98 In response to a question of systemic failure of the Committee, the witnesses stated that in fact the irregularities had started two three years ago but the real problem in the Bank started when all the powers of the Board were given to a single member to take all investment decisions. It was denied that prima-facie, any auditor was involved in the irregularities.

5.99 On being asked by the Committee as to why irregularities could not be detected earlier, the RCS, UP stated that when the Bank was inspected by the RBI in March, 1999 any irregularity like siphoning off funds etc. did not come to their notice at that time. The happenings of 27.2.2001 came to the notice of public in March. Moreover, the RBI granted the licence in February, 2001 to the Bank to open four new branches, which gave an impression that the Bank was running in good condition and without any shortcomings. He suggested that there is a need for regular concurrent audit of the UCBs.

5.100 The Committee then took oral evidence of the former officials of the Bank, namely, Shri Anand Krishna Johari, former Director, Shri Arvind Johari (brother of Sh. Anand Krishna Johari) and Shri Gorakh N. Srivastava, former Secretary/CEO.

5.101 On being asked by the Committee as to how the Bank accounts of the four companies, namely, Cyber Space Infosys, Kamal Infosys Ltd., Kamal Infosys Integrated Technologies Private Ltd. and Country Informtech Services Private Ltd. controlled by Shri Anand Krishna Johari were opened without observing the usual procedure as introduction, obtaining of Memorandum of Articles of Association etc., Shri Anand Krishna Johari denied this by stating that all the relevant papers must be there in the files.

5.102 On the query of the Committee that during the period from 5th to 15th March, 2001 the Bank's funds totalling about Rs. 6.5 crore were invested in the Bonds of Cyberspace Infosys in violation of the RBI guidelines, Shri Anand Krishna Johari submitted as under:

"To my knowledge, the Bank was investing in equities and bonds. As much as I can remember, I do not remember if any investment was made in Cyberspace. I do not have any documents. For the past ten months or more, I have been in jail. So, I do not remember anything. In case we get some of these documents, we would be able to tell about it exactly."

He denied that he had any knowledge of RBI report wherein it is mentioned that Bank's funds to the extent of Rs. 6.87 crore were invested in Cyberspace Infosys Ltd. in violation of RBI guidelines. He stated that Cyberspace Infosys had an account with the Bank with several FDs and it could be possible that the money could have been advanced against the FDs.

5.103 During evidence, the witness Shri Anand Krishna Johari denied that he was Director (Finance) before 1999 and taking investment decisions of the Bank while stating that there was an Investment Committee. However, this statement was contradicted by Shri Gorakh N. Srivastava, former Secretary/CEO who stated that the responsibility for making Bank's investments rested with Shri Anand Krishna Johari. The former CEO stated that Shri Anand Krishna Johari was telling a lie before the Committee because the Bank's money was invested in accordance with his wishes as he was a powerful Director.

5.104 Regarding his relationship with the Bank, Shri Anand Krishna Johari submitted that he became a Director in the Bank in the year 1999. Some officers of the Bank used to consult him for investment. The names of these people were Shri Srivastava, Shri Prem Prakash and Shri Manish Agarwal. In this regard, Shri Arvind Johari submitted that he was not associated with the Bank as he was living in Mumbai for the last 7 or 8 years.

5.105 The Committee pointed out that according to RBI report, out of the total investment of Rs. 30.82 crore, there was no documentary proof regarding investments of Rs. 21.40 crore and desired to know the reasons for the disappearance of Johari brothers. In response, Shri Anand Krishna Johari submitted :

"There was a very acute problem in the stock market in the month of March, 2001. We were running a stock broking house in the name of Century Consultants, which was a member of the BSE and the NSE, and I was responsible for those operations. We had a major crisis of payment in the market because of the sudden fall in the index. There were a very large number of clients who had lost money and were not coming up immediately for payment. We had a liability in the Exchange and we had certain creditors to whom payments were to be made."

He took the stand that he was not aware as to why Rs. 21 crore out of a total investment of Rs. 30 crore were unaccounted because he had not been able to work out any of these details so far because of the reason of his being in jail for the last 10 months.

5.106 On being asked by the Committee as to who were the people on the Board of Cyber Space Infosys Ltd., Shri Anand Krishna Johari stated that he was a Director and one Shri Sanjay Saxena, Shri Pankaj Kumar and their father Shri Gyanendra Nath Johari, all of them belonging to Lucknow were on the Board of Directors and Shri R.V. Aroskar and Shri Kiran Aroskar (from Mumbai) and Shri R.K. Pradhan (in U.S.) were also on the Board. According to him, Cyber Space Infosys was initially a finance company and converted into a software company somewhere around in 1995 or 1996.

5.107 On being asked by the Committee as to what was the relationship between the above mentioned four companies and whether these were set up at about the same time, Shri Anand Krishna Johari stated that Kamal Infosys was a very old company which was set up eight or nine years ago. He did not remember the details of other companies.

5.108 Shri Gorakh N. Srivastava separately gave oral evidence before the Committee. He submitted that he was under the impression that Shri Anand Krishna Johari was working for the welfare of the Bank and he was not aware that one day he would bring the Bank to a crisis. He further submitted that the Johari's had made some investment in a finance company of Mumbai promising that the Bank would get good returns. According to his estimates, around Rs.16 to 17 crore was the unaccounted money used by the Joharis in investments.

5.109 The Committee regret to note that the City Cooperative Bank flouted all prudential norms of the RBI. This became clear during the investigation conducted by the RBI. The Bank had no investment policy, loan disbursement policy and credit appraisal system. Carrying out a concurrent audit was also missing. The Bank had opened deposit accounts in respect of four front companies of the promoter of M/s Century Consultants Group viz. Shri Anand Krishna Johari who was also a Director on the Board of the Bank. The accounts were opened without observing the usual safeguards such as introduction, obtaining of Memorandum and Articles of Association etc. The Board had vested full powers of investment on Shri Anand Krishna Johari and all investment decisions were taken by him. The result was that between 5th and 15th March, 2001, the Bank's funds to the extent of Rs. 6.50 crore were utilized for investments in bonds of Cyber Space Infosys - a concern of Shri Johari, contrary to RBI instructions prohibiting equity investment in such companies. There was also a total absence of any loan policy/committee and all credit decisions too were taken only by Shri Anand Johari. The Bank had invested funds to the extent of Rs. 15.68 crore in term deposits and receipts aggregating to Rs. 2.62 crore could not be produced to RBI for verification during the investigations. It was noticed that these were however encashed but not accounted for and the proceeds had simply been siphoned off. Similarly, the Bank did not have any documentary evidence in respect of a large amount of investment amounting to Rs. 21.40 crore indicating that the money had been misutilised by Shri Anand Krishna Johari. The advances were disbursed on the orders of the Secretary cum CEO. In addition, advances against shares in physical form were granted in excess of the ceiling of Rs.10 lakh per individual as prescribed by the RBI which resulted in turning the entire portfolio to the tune of Rs.1.53 crore into NPAs. Furthermore, the Bank had violated RBI directives on unsecured advances by sanctioning limits in excess of Rs.50,000 in a number of cases, in blatant violation of the RBI directive on maximum limit in relation to unsecured advances. During the period January-March, 2001, the Bank had sanctioned large advances to the tune of Rs.5.88 crore to 15 borrowers without the backing of any tangible security in blatant violation of RBI directives. Astonishingly loans were sanctioned even against blank applications and without obtaining signatures on the necessary documents. Advances and funds were released by way of demand draft without ensuring their end use.

5.110 The Bank had reportedly violated RBI guidelines on credit exposure in respect of the individual exposure norms of 20% of its capital fund and group exposure norm of 50% of its capital fund in several cases. The liquidity position of the Bank was extremely unsatisfactory as the deposit liability of the Bank as on the date of scrutiny i.e. 22/3/2001 stood at Rs. 65.90 crore against the liquid assets of Rs. 8.14 crore. The Bank had also circumvented the CRR guideline as laid down under Section 18 of the Banking Regulation Act, 1949. It had adopted a novel way of inflating its balances with notified/eligible Banks in its books of accounts by booking fictitious debit entries. The Committee also note that there was no system of concurrent audit and the

Bank had also violated RBI guidelines on income recognition, asset classification and provisioning. This ultimately resulted in systematically siphoning off the Bank's funds to the tune of Rs. 32.30 crore through the companies of Shri Anand Krishna Johari and turning negative the networth of the Bank.

5.111 Neither the State Registrar under whose direct control the Bank functions nor the RBI which is an apex regulator in the case of urban cooperative banks came to know of the misuse of powers and flagrant violation of regulations/directives of the RBI until a public outcry and news in the press. Though under the UP Cooperative Societies Act, 1965 wide powers of conducting inspections, enquiry and audit are vested with the Registrar of the Cooperative Societies, these powers were not exercised to check the functioning of the Bank. RBI too surprisingly issued licences as late as February, 2001 for opening four more branches of the Bank, thereby giving an impression that the Bank was functioning well. In fact even when in the annual inspection report of 1999, the RBI had clearly indicated some glaring irregularities and the auditors of the State Cooperative Department for the period 1997-2000 had pointed out serious irregularities, immediate steps were not taken for rectifying the irregularities. This leaves the Committee with the impression that both the RCS as well as RBI showed laxity in discharging their duties even prior to March, 2001 when the run on the Bank surfaced.

5.112 The Committee were informed that RBI has filed criminal complaints against the Chairman, Secretary- cum- Chief Executive Officer and 11 other Directors in the Court of Chief Judicial Magistrate, Lucknow. In addition two FIRs dated 2nd May and 18th May, 2001 were also lodged against the erstwhile Director Shri Anand Krishna Johari and erstwhile Secretary Shri Gorakh Nath Srivastava for siphoning off funds from the Bank in the form of fake investments etc. to the tune of Rs.30 crore approximately. The second FIR related to siphoning off funds in the form of cheque purchase for Rs. 1.71 crore. These two cases were subsequently taken over by CBI in July, 2001. Whereas in one case CBI has filed a charge sheet, investigations in the other case are not yet over. Departmental proceedings against Shri Gorakh N. Srivastava have also been initiated.

5.113 In view of the foregoing observations, the Committee recommend the following specific action:—

- (i) In order to expedite action on the criminal complaints which are presently pending adjudication in the Court of the Metropolitan Magistrate, Lucknow, it is recommended that such case be tried by a Special Court.
- (ii) UP Government may be asked to initiate further enquiry against the concerned State Registrars for not being vigilant and exercising supervision on the working of the Bank even when the UP Cooperative Societies Act, 1965 empowers the Registrar to hold an enquiry into the working of the co-operative society, carry out inspection on his own and even supersede the Committee of Management in case it is found that any act is committed which is prejudicial to the interest of the society or its members or otherwise if the society is not functioning properly. This should be done expeditiously.
- (iii) CBI must complete the investigations expeditiously in the case wherein FIR has been filed for siphoning off funds in the form of cheque purchase for Rs. 1.71 crore.
- (iv) RBI must introduce a system whereby the irregularities pointed out in the annual inspection Reports are removed by the Banks and compliance report is submitted within a period of six months from the date of inspection.

- (v) Strict penal provisions be incorporated in the Banking Regulation Act 1949 for non-compliance of the directives/guidelines issued by the RBI from time to time and in case of default, strict disciplinary action should be initiated against the erring officials.
- (vi) As an apex body, though it is not possible for RBI to monitor each and every transaction, it is essential that concurrent audit is conducted in the Banks on a regular basis. The Reserve Bank of India may consider making this mandatory.
- (vii) Investigation must be conducted to unearth where the siphoned money (Rs. 32.30 Crore) has been deployed. Expeditious action is needed to recover the money.

**(c) Other Cooperative Banks**

5.114 Urban Cooperative Banks were, until 19.4.2001, permitted to lend against pledge of shares only to individuals upto Rs.10.00 lakh if the shares are in physical form and upto Rs. 20.00 lakh if they are in the demat form. Urban Cooperative Banks were prohibited from extending any financial assistance to stock brokers. RBI collected information in regard to advances granted to stock brokers by some urban cooperative banks. The names of 25 Urban Cooperative Banks which violated Reserve Bank of India guidelines on lending against shares/ debentures by granting advances to stock brokers are as under:—

1. Mahesh Coop. Urban Bank Ltd. Hyderabad
2. Abhyudaya Co-op. Bank Ltd. Mumbai
3. Adinath Coop. Bank Ltd. Surat
4. Akola Urban Coop. Bank Ltd. Akola
5. Anyonya Coop. Bank Ltd. Baroda
6. Bhopal Nagrik Sh. Bank Ltd. Bhopal
7. Bombay Mercantile Co-op. Bank Ltd. Mumbai
8. Citizen's Coop. Bank Ltd. Jammu
9. City Coop. Bank Ltd. Lucknow
10. Gandhi Nagar Sah. Bank Ltd. Gandhi Nagar
11. Greater Bombay Co-op. Bank Ltd. Mumbai
12. Indore Cloth Market Coop. Bank Ltd. Indore
13. Jaihind Co-op. Bk. Ltd. Ambernath
14. Jain Sahakari Bank Ltd. Mumbai
15. Jalgaon Janata Sah. Bank Ltd. Jalgaon
16. Janata Sahakari Bank Ltd. Pune
17. Jivan Com. Coop. Bank Ltd. Rajkot
18. Madhavpura Mercantile Coop. Bank Ltd. A'bad
19. Meenachil East Urban Coop. Bank Ltd. Thekkekara
20. Nagrik Sah. Bank Mydt. Gwalior

21. National Coop. Bank Ltd. Ahmedabad
22. Rupee Co-op. Bank Ltd. Pune
23. Shree Labh Co-op. Bk. Ltd. Mumbai
24. Social Coop. Bank Ltd. Ahmedabad
25. Surat Peoples Coop. Bank Ltd. Surat

5.115 RBI stated that while the advances granted by Madhavpura Mercantile Co-operative Bank Ltd., Ahmedabad, to share brokers/their associate concerns aggregated Rs.1082.22 crore forming 68% of its total loans and advances outstanding as on March 24, 2001, such loans by the remaining banks were not substantial. According to the RBI, in view of the highly volatile nature of capital market and urban cooperative banks being repositories of deposits of small and middle income groups as also due to the fact that such banks do not have expertise to deal in the stock market, the Reserve Bank of India has decided to prohibit these banks from granting any financial assistance against security of shares and debentures effective from 19.4.2001.

**5.116 The Committee note that RBI has taken note of the irregularities committed by these UCBs and is taking appropriate action. The various aspects relating to the capital market exposure of some Urban Cooperative Banks in violation of RBI guidelines and the subsequent steps taken by the RBI to do away with the shortcomings in the Urban Cooperative Banking sector and various systematic reforms introduced or proposed to be introduced to strengthen the surveillance and vigilance mechanism have been dealt with in detail under the chapter 'Reserve Bank of India' of this report.**

### **3. COMMERCIAL BANKS**

#### **Global Trust Bank**

5.117 Global Trust Bank was incorporated in 1993 and was promoted by Ramesh Gelli, Jayanta Madhab and Sridhar Subasri and others. It went public in August 1994 and began operations on 10.9.1994.

5.118 In relation to the Stock Market scam, the GTB was investigated broadly on the following issues:

- (i) High exposure to capital market by way of advances against shares and guarantees;
- (ii) Fluctuations in the prices of the GTB shares and allegations of insider trading in GTB scrip and share swap ratio for the proposed merger of the GTB with UTI Bank;
- (iii) Diversion of funds taken as loan from the Bank by Ketan Parekh entities and others.

The above issues have been dealt in the succeeding paragraphs.

#### **Exposure to the Capital Market**

5.119 The commercial banks are permitted to invest in shares and debentures of corporates and grant advances against shares in terms of the provisions of the Banking Regulation Act, 1949. The Bank's exposure to the capital market takes the form of;

- (i) Investment in shares, convertible debentures and units of equity oriented mutual funds where the banks take the price fluctuations upon themselves.

- (ii) Advances against shares, which were subject to market risk but covered by the margin requirements.
- (iii) Non-fund based facilities like guarantees, where credit risk arises on account of non-performance of the obligation.

5.120 The Reserve Bank of India, issued instructions in November, 2000 that a bank's exposure to capital market by way of investment in shares, convertible debentures and units of mutual funds (other than debt funds) were not to exceed a prudential ceiling of 5% of the bank's domestic advances as on March 31, of the previous year. Three banks, Karnataka Bank, Bank of America and Development Credit bank had exceeded the 5% limit as of 31.1.2001. It was not considered necessary to prescribe an overall ceiling for advances against shares and issue of guarantees by the bank since shares are taken as security/collateral which were subject to mark-to-market discipline and therefore volatility in the asset prices in the stock market would not affect the value of the asset. RBI has further deposed that—when we brought the November 2000 circular, the reason why we have not included both investment and advances in the 5% is that we should not put too many restrictions on the banks' lendings to stock market, otherwise the flow of funds would be restricted. The Board of Directors of each bank was therefore, given the authority to lay down the ceiling for total advances against shares.

5.121 A review made by RBI during first half of the year 2000, revealed that the exposure to capital market by way of advances against shares, guarantees issued on behalf of brokers and financing of IPOs of four newly set up private sector banks (viz. Global Trust Bank, HDFC Bank, Bank of Punjab and Centurion Bank) was on the high side. Subsequently, it was also found that the Bank of Madura (since merged with ICICI Bank) had granted IPO financing of large amounts. The review also revealed that the GTB's exposure to the capital market by way of advances against shares and guarantees issued on behalf of the brokers was on the higher side. The Bank was advised in June, 2000 to bring down its capital market exposure to a reasonable level. During March 2001, RBI conducted a scrutiny of capital market exposure of the Bank again and it was found that though the Bank had complied with the regulatory norm of investments in shares, debentures etc, upto 5% of the Bank's advances, but the Bank had set relatively higher ceilings for financing individuals, brokers against security of shares as also guarantees on behalf of the stock brokers. It was, however, also noticed that not only the ceilings fixed by the Bank's Board were relatively higher, but even the higher ceilings were exceeded by the bank which were however ratified by the Board. The overall exposure of the bank as on 31.1.2001 stood at Rs. 1016 crore comprising fund based and non fund based and formed 31.6% of funded advances as on 31.3.2000. Subsequently, this overall fund and non-fund exposure was brought down to Rs. 795 crore as on 31.5.2001. Similarly, it was found by the RBI that UTI Bank's Board had taken exposure exceeding the relatively high ceilings fixed by the Board. UTI Bank's explanation was called by RBI, and the bank was issued a letter of displeasure.

5.122 It was observed that the Bank had taken large exposure to a particular stockbroker and its related entities. The Bank had extended fund-based and non-fund based facilities to the firms/companies in which Shri Ketan Parekh was said to be interested. The aggregate fund based facilities extended to Ketan Parekh Group of companies stood at Rs. 219.52 crore as on 31 March 2001 and non-fund based facilities like guarantees amounted to Rs. 26.25 crore as on the same date. Shri Ramesh Gelli, whose term of office was approved till 30.6.2001, was advised to step down and accordingly, he relinquished his position on 12.4.2001. On the basis of findings of the scrutiny of RBI, the bank's explanation for its high exposure to capital markets was called for on 10.5.2001. As the explanation was not found satisfactory, a letter of displeasure, dated 3.7.2001, was issued to the Bank.

5.123 In the light of these developments, where some private banks had built up relatively large exposure to capital market including concentrated exposure to a few brokers and their associates/inter connected companies by a bank, the revised guidelines were issued by the RBI on 11.5.2001 in order to regulate a bank's exposure to capital market by way of investment in shares, advances against shares as also guarantees on behalf of the stock brokers with a prudential ceiling of 5% of the bank's outstanding advances as on 31 March of the previous year. As per these guidelines, a bank's investment in equity shares, convertible debentures and units of equity oriented mutual funds should not exceed 20% of the bank's networth. In order to avoid any nexus emerging between inter-connected stock broking entities and banks, the Board of each bank have been advised to fix within the overall ceiling of 5%, a sub-ceiling for total advances to all stockbrokers and market players as also to any single stock broking entity, including its associates/ inter connected companies. The banks have also been prohibited from undertaking arbitrage operations themselves or extend credit facilities directly or indirectly to stockbrokers for arbitrage operations. A uniform margin of 40% has also been prescribed on all advances/financing of IPOs/issue of guarantees. A minimum cash margin of 20%(within the margin of 40%) is required to be maintained by the banks for issue of guarantees on behalf of the brokers.

5.124 Explaining the reasons for entering into capital market investment, a representative of the bank stated during evidence before the Committee that particularly with the dematerialisation of shares, the Bank saw an important opportunity in the capital markets very early. He went on to explain that at the same time the bank had put all the risk management systems in place. While giving his comments on the high exposure, Shri Ramesh Gelli, the Ex-Chairman of the GTB stated that the bank had not breached any directives of the RBI, because till May, 2001 the main guidelines of the RBI related to a cap on the Bank's investments *i.e.* they should not exceed 5% of the incremental deposits and the Bank's investment were always between 2-3%. As regards lending to brokers and other capital market exposure, it was left to the Boards of each bank to decide. Initially the Bank's Board decided for an exposure up to 15% which was initially 10% in 1997. The Bank had not breached any of these limits except one or two odd occasions, all of which were ratified by the Board. The Bank certainly had a high exposure to the capital market but the logic to take this high exposure was adequate and substantial.

#### **Fluctuations in GTB share prices and merger proposal between the GTB and UTI Bank**

5.125 The Market Intelligence Cell, Department of Banking Supervision monitors the share prices of all listed banks on a daily basis, among other things. Any large variation in share prices either upwards or downwards, is analysed by them. During the course of supervisory exercise and analysis of share prices of bank scrips conducted by Market Intelligence Cell of the Department of Banking Supervision, it was observed that share price of GTB scrip had risen from Rs. 68.70 as on 13.10.2000 to Rs. 92.65 as on November 10, 2000 showing an increase of 34.86%. The major surge in prices had been noticed during the period from October 27 and November 10, 2000. The bank had reported a rise in 51.23% in net profit at Rs 68.60 crore for the half year ended September 30, 2000 as compared to the corresponding period the previous year. During the middle of October, 2000 media reports about a market player reportedly holding over 5% stake in the bank had appeared. As the holding of shares in excess of 5% requires prior approval of RBI and since no reference had been received from GTB in the past, the RBI wrote to SEBI on 24.11.2000 asking them to make further enquiries to enable RBI to examine the matter. Market Intelligence Unit of RBI does not appear to have responded to large price increases of other banks during the same period of October-December, 2000. At least 12 banks have shown increases of above 50% with two banks—Bank of Madura by 325% and United Western Bank by 125%. The Market Intelligence Unit has only written about GTB to SEBI.

5.126 While reply of SEBI was awaited in the RBI, UTI Bank Ltd. and GTB decided to merge on business considerations and for expansion of customer base. Two banks commenced discussions on 15.12.2000 and the merger announcement was made on 23.1.2001. SBI Caps was nominated by both the banks as Merchant Banker and to conduct the valuation of both the banks, leading to determination of swap ratio. SBI Caps, on the basis of four parameters of valuation, share price being one of them (the lower of the average share price of the past six months or the past two weeks was considered as the basis), evolved the swap ratio as Nine UTI Bank shares for four GTB shares. UTI Bank had also obtained a second valuation from Delloitte Haskins & Sells (DHS), who had also used multiple parameters, one of them being share price. DHS had also ignored periods of high price of GTB, within immediate six months and still arrived at the Swap ratio of Nine UTI Bank shares to four GTB shares. During the period of negotiation, the share price of GTB, which was Rs. 89 on 15.12.2000, came down to Rs. 80 on 23.1.2001. The share price of UTI Bank was Rs. 45.15 on 15.12.2000 and Rs. 48.00 on 23.1.2001. A memorandum on amalgamation was placed before the meeting of the Board of Trustees of the UTI at its meeting held on 25.1.2001. The Board of Directors of UTI Bank Ltd. approved the proposal of amalgamation at its meeting held on 27.1.2001. Prior to this a shareholders' agreement was signed by the Chairman, UTI, Chairman UTI Bank Ltd, Shri Ramesh Gelli CMD of GTB Ltd and another official of GTB on 24.1.2001. The proposal for the merger was approved in the Extraordinary General Meeting (EGM) of both the banks held on 24th and 26th February respectively and in this meeting the shareholders passed Resolutions by the requisite majority of 2/3rds of the members present and voting (including proxies) as required in terms of provisions of Section 44 A of the Banking Regulation Act, 1949. The Governor, RBI, during his deposition, had informed the Committee that there was nothing illegal in the merger proposal of GTB and UTI Bank.

5.127 GTB advised RBI on 4.4.2001 that the merger proposal may be treated as closed. A copy was sent to UTI Bank Ltd. on the 4.4.2001 informing the Bank that the merger proposal was being treated as closed by RBI.

5.128 SEBI has mentioned that large funds were given as loans to Ketan Parekh entities by GTB, were applied in the capital market as per sanction objectives. Funds given as loans to certain corporate houses by GTB were also found to have been transferred to Ketan Parekh entities. It was also noticed that two companies controlled by Ketan Parekh viz. Nakshatra Software Pvt. Ltd. (6,00,000 shares) and Chitrakut Computers Pvt. Ltd. (7,17,650 shares) were allotted shares on preferential basis by GTB in March 2000. This allotment was on a private placement basis. This shows that Ketan Parekh entities were known to promoters of GTB. SEBI has further pointed out that on the basis of the Preliminary and Interim Investigation Report, it was established that price of shares of GTB were manipulated for the period October 2000 to February 2001 i.e, prior to announcement of proposed merger of GTB with UTI Bank. As regards possibility of price manipulation during the earlier period of October-November 1999 to February 2000 prior to preferential allotment of shares in March 2000, NSE was asked to conduct an enquiry. However, in the preliminary report received from NSE, it was found that angle of price manipulation has not been dealt with and they have been asked to further report in the matter.

5.129 During the course of the evidence, the Ex-Chairman of GTB did not totally rule out that there could have been rigging in the shares of GTB. He however, stated that the promoters had nothing to do with it and it was an independent phenomenon and during this period at least 12 other banks had shown rise of more than 46% in their share prices. He stated that the bank did not have any information that Ketan Parekh Group of Companies had crossed 5% limit. He also denied that increase in the share prices had affected the swap ratio. On the understanding which was created between the GTB and UTI Bank relating to merger, the Ex-Chairman informed that one understanding was that the merger would happen on the basis of an independent valuation. Secondly, the merged Bank would be named as UTI Global Bank and headed by the

CMD of UTI Bank and he would continue to be on the Board of UTI Global Bank. Further understanding was that the registered office would continue to be in Hyderabad while the business office could be in Mumbai. Afterwards, the UTI Global Bank would promote an insurance company and then as a promoter, he would come in and offered the position of Chairman. He also stated that various allegations viz. manipulation of prices, insider trading prior to announcement of the merger, manipulation of prices prior to the preferential issue and collusion/nexus between him and the Ketan Parekh Group made by SEBI were not true. He further stated that the merger proposal was called off on 4.4.2001 because the whole atmosphere had become vitiated and there was no way these two groups of people could work together except suspecting each other.

5.130 Regarding utilisation of the Bank's own funds by the KP Group of companies to purchase GTB shares, a representative of the Bank informed the Committee that their audit department had made a complete study in March, 2001 of the utilization of the funds by the KP Group of Companies for the period from October, 2000 to February 2001 and they have gone through every transaction and found that no money from GTB was utilised to fund GTB shares. The audit was satisfied that the funds of GTB were not involved in the purchase of GTB's shares.

5.131 To the question whether it was a fact that the promoters of GTB had bought shares of GTB at a lower price and they were later sold at a higher price, the Ex-Chairman submitted that GTB had two technical partners at the commencement of the Bank, namely, M/s Hambrecht & Quist from USA and TA Enterprises from Malaysia. In the second half of 1999, both wanted to exit GTB for different reasons. While as per previous agreement, both are to make the first offer to the promoters, H&Q with their global experience always preferred to sell only to promoters, so that there are not subsequent issues. While the promoters expressed their inability to buy, and wanted them to sell in the market, partners still preferred to sell it to the promoters. Promoters then negotiated the price, finalized the transaction and purchased the shares with the approval of RBI, which approval included the price of the shares and kept SEBI and Stock Exchanges fully informed of the transactions.

5.132 SEBI in its second interim report of December 2001 analyzed the price movement of GTB in four periods as follows:

Period marked as	From date	To date	Price at the beginning of the	Price at the end of the period
A-A	21.11.99	08.12.99	Rs. 43.40	Rs. 63.20
B-B	15.12.99	23.12.99	Rs. 60.00	Rs. 74.60
C-C	30.12.99	10.01.00	Rs. 67.00	Rs. 81.00
D-D	25.01.00	03.02.00	Rs. 78.00	Rs. 101.50

5.133 SEBI has also confirmed that promoters have not sold any shares during the period marked B-B, C-C, D-D. It therefore appear that the promoters sold most of the shares purchased from technical partners early on, and did not benefit in subsequent price rise/manipulation if any.

5.134 SEBI has also stated in second interim report of December 2001 that Ketan Parekh entities purchased GTB shares from bulk sellers and the promoters of GTB in late 1999. The phenomenon of synchronized trading which was widely prevalent in the market was also found

in the above transactions. SEBI has since confirmed that synchronized deals are *ipso facto* not illegal. SEBI has also confirmed that in the screen based trading that is prevalent in the stock exchanges now, the buyer or the broker will not be aware of the identity of the seller or the broker. SEBI has further confirmed that most of the GTB shares from promoters and from others purchased by Ketan Parekh entities during the period of last quarter of 1999 were placed by Ketan Parekh entities to an FII client, DBMG of Mauritius.

5.135 SEBI has also confirmed that Asian Development Bank (ADB) has sold its entire holdings of 1.00 crore shares on 11.4.2000 @ Rs.83/- per share. SEBI has also since confirmed that the entire shares sold by ADB through ICICI Brokerage Services Ltd. at NSE and BSE were purchased by few broking entities associated/connected with Ketan Parekh. It is observed that these trades were also synchronized trades.

5.136 During the deposition, Ex-Chairman has also confirmed that for the full year, April 2000 to March 2001, the promoter group purchased 3.59 lakh shares of GTB and sold 90,000 shares of GTB, out of a total of 12.10 crore equity shares issued by the GTB. The second valuation report on the GTB-UTI Bank merger swap ratio, computed by DHS at the request of UTI Bank, had ignored periods of high prices of GTB in the previous six months, and still arrived at the same swap ratio of nine UTI Bank shares for four GTB shares, as earlier determined by SBI Caps. Thus, as a result of price manipulation, if any, during the period of October 2000 to February 2001, *i.e.* prior to announcement of proposed merger of GTB with UTI Bank, the promoters have not benefited as a result of price increase if any, either by sale of their holdings at higher prices or beneficial swap ratio. SEBI's investigations do not show promoter corporate involvement in price manipulation of the GTB scrip. However, it is seen that IFC, Washington, which is one of the initial allottees of equity in Global Trust Bank, sold 13.90 lakh shares between 15.12.2000 and 31.12.2001.

5.137 On the question of preferential offer on a private placement basis, in March 2000, the Ex-Chairman submitted that there were basically ten major allottees. In all 14.8 million shares were issued at a price of Rs. 85 per share. Out of these, the two namely, Nakshatra with 600 thousand shares and Chitrakoot with 719 thousand shares—totaling 1.3 million shares—were subsequently reported to have been connected with the KP Group. The 1.3 million shares constitute 8.91% of the preferential allotment and 1.09% of the total issued capital. He however denied that there was any nexus of the Ketan Parekh Group of Companies with the promoters of the Bank. Shri R. S. Hugar, the CMD of the Bank in September, 2000 confirmed in his deposition to the Committee that, in his opinion, there was no nexus between KP group and promoters of GTB.

5.138 Since most of the allegations made by SEBI in their investigation report were denied by the Ex-Chairman Shri Ramesh Gelli, SEBI was asked to comment. In their detailed reply, SEBI confirmed their earlier findings but could not substantiate them as seen above. So far as the question of insider trading is concerned, SEBI stated in their reply as under:

“No evidence has been observed so far, which would bring the sale transactions of the promoters within the ambit of Insider Trading Regulations. In none of three reports submitted to JPC there are any findings indicating insider trading by the promoters.”

#### **Diversion of Funds**

5.139 The Committee has observed that there have been many instances of diversion of funds by borrowers in many banks and institutions and generally the banks have expressed their helplessness and inability to fully monitor the end use of funds. The Committee were informed by RBI in their written replies that GTB had granted loans to the Group companies of HFCL and

Zee Tele. The outstanding amount extended to the group of HFCL stood at Rs. 212.98 crore and to Zee Telefilm Group at Rs. 250.48 crore as on March, 2001. The Committee were informed that loans were given by GTB to the Zee Group as they were credit worthy client and a blue chip company, for strategic acquisition of buying shares of companies like B4U, Multi-Media International, ABCL, Mascom Global, Mukta Arts, Tips Industries, Shonk Technologies and Crame Software International. It was brought to the notice of the Committee that the loans to Zee Group were given in March, 2001 for purchase of shares and when the Bank came to know in July, 2001 that the shares were not being delivered, they recalled the loan in September, 2001.

5.140 Three questions have arisen on the basis of above findings.

- (a) Whether the corporates, Zee and HFCL diverted funds borrowed from GTB.
- (b) The funds on reaching Ketan Parekh group, how were the same utilized.
- (c) Whether the funds were used by Ketan Parekh entities to manipulate the prices of Zee and HFCL shares.

5.141 GTB loans to Zee group were in the form of Corporate Loans where borrower has flexibility in use of these funds, were credited to current account of borrowing companies. Zee group has indicated to GTB that they are using the funds for acquiring the stake in related business of media and entertainment industry.

5.142 In the case of HFCL group, RBI has stated that loans to HFCL Infotel and HFCL Satellite Communication were sanctioned on the basis of detailed appraisal reports and in both cases loans were disbursed to the borrowers by way of reimbursement of expenses already incurred by them for project implementation. Since the common parent for both the borrower, *i.e.* HFCL had provided funds and other implementation services to the borrowers, the loans released to the borrowers were transferred to HFCL. The scrutiny conducted by RBI on July 21st and 23rd, 2001 did not reveal that the loan amounts to the two companies were not used for the stated purposes. The loan to parent HFCL was also by way of financing of receivables of turnkey projects already executed.

5.143 SEBI has confirmed that Zee and HFCL group have provided funds to Ketan Parekh to acquire strategic stake in media and entertainment industry and mainly in unlisted companies. By and large this understanding has been reduced into written contracts between entities connected with Ketan Parekh and Zee/HFCL groups. These documents have been verified by SEBI. However, it is also stated by HFCL and Zee groups that a part of the contract have not been fulfilled as Ketan Parekh group has failed to deliver the shares.

5.144 SEBI further confirmed in the case of HFCL that there are no indications so far that the promoters were involved in the manipulation/jacking up of prices.

5.145 SEBI in its investigation report on Zee Telefilms Ltd. of September 2002, also indicated that Department of Company Affairs had inspected the books of accounts, records and other documents of Zee Telefilms and the group companies like Ganjam Trading Pvt. Ltd., Briggs Trading Pvt. Ltd., Digital Superhighway Pvt. Ltd., Siti Cable Networks Pvt. Ltd., which did not bring out that these companies have given funds to broking entities for buying or selling the shares of ZTL and directly or indirectly dealt in the shares of ZTL.

5.146 The SEBI report also confirms that majority of the funds were provided by HFCL group and Zee group to KP entities, mainly in the end of 2000 and first quarter of 2001 during the period when the prices of these scrips were coming down from their peak. The fall in prices in

the software and entertainment and technology industry during this period appeared to be a worldwide phenomenon.

5.147 SEBI has confirmed that investigations carried by SEBI indicate that entities connected with Ketan Parekh used the funds received from HFCL group and Zee group for payments to other brokers and meeting their own settlement obligations with the stock exchanges.

5.148 The RBI in their inspection report of the Bank with respect to the position as on 31.3.2000 has observed that despite being pointed out in the previous annual financial inspections, delegated powers were exceeded by the Branches as a matter of routine rather than resorted to in exceptional and deserving cases. One such instance of acceding to delegated powers was noticed at the Nariman Point Branch. The Branch released substantial advances without receipt of sanction letter from the Corporate Office. The sanction included release of an amount of Rs. 89.75 crore on 2.3.2000 to First Global Stock Broking (P) Limited and five of its associates, out of which three were newly formed investment companies by the same promoters. It may be added that the First Global Stock Broking (P) Ltd. was already enjoying substantial funded and non-funded facility at the bank's Fort branch sanctioned by Committee of Board and release of such large amount of funds by the branch without receipt of regular sanction from the appropriate authority was highly irregular as it ignored the implications of adherence to group exposure norms. The scrutiny of records revealed that the entire amount was utilized towards acquisition of shares of Himachal Futuristic Communications Ltd. which was also the purpose for which the funds were provided. The Corporate Office had advised the branch, *vide* letter dated 7.3.2000 to recover the advances. The loans released on 2.3.2000 were completely repaid and accounts closed by 31.3.2000.

5.149 RBI in their inspection Report for 2000-01 pointed out some of the deficiencies which existed in the Bank and these were as under:—

- (i) No application was obtained from the broker-borrower in many cases;
- (ii) Neither proposals nor recommendations from the branch were obtained;
- (iii) Frequent transfer of funds from one account to other accounts of the same group through fresh sanctions was allowed for the purpose of evergreening;
- (iv) Companies with meagre network, were extended huge limits without studying the cash flows and analyzing repayment potential;
- (v) Large number of credit proposals were sanctioned through circulation among the members of the Committee of Board (COB) which comprised four members including the Chairman and Managing Director and Executive Director. However, the Committee observed that an analysis of a sample set of banks revealed that most banks have shown weakness in formulation of credit policies, implementation of internal credit policies, and monitoring and supervision. There are also gaps in risk management areas in these banks.

5.150 During the course of evidence, the RBI informed the Committee that diversion of funds is not a specific violation under the Banking Regulation Act, though normally, bankers are expected to ensure the end use of funds. The RBI has informed the Committee that whenever there is a violation of any provision of the B.R. Act, or any directive of the RBI, the bank would be imposed monetary penalty. The RBI has further stated that there were 44 instances where penalties have been imposed on banks, varying from Rs.1.00 lakh to Rs.1.52 crore. No monetary penalties have been imposed on GTB till March 2001. Also in respect of deviations to bank's

own internal guidelines, banks are required to fix accountability against erring staff and initiate appropriate disciplinary procedures as per the established procedure and following due procedure of law.

5.151 In their subsequent report contained in Office Memorandum dated 24.6.2002, the Department of Company Affairs (DCA) has observed that there has been following violations by the Bank:

- (a) Violation of Sec. 217(1)(d) where the Board's report dated 30.4.2001 has not explained the material changes that have taken place relating to scam related matters.
- (b) Violation of Sec. 292(1)(d) of the Companies Act, when the Bank has not passed a proper resolution relating to making investments of its funds in various government securities and corporates.
- (c) Violation of Sec. 292(1)(e), where the Board of Directors of the Bank have not passed any resolution relating to making loans/advances.
- (d) Violation of Sec. 211, interest paid on statutory liquidity ratio has not been properly charged and classification of application money for NCD, bonds and for equity preference shares not properly made.
- (e) Violation of Sec. 228(1) where the resolutions passed at the AGMs of the Bank appointing statutory auditors did not specifically mention that they would also audit the branches of the Bank.

5.152 The memorandum further states for violations (a), (b) and (c), the DCA have already issued warning letters to the Bank dated 7.3.2002. As regards violations (d) (e), the Department has also mentioned that warning letters to the Bank are being issued. Further, the Memorandum states that there have been certain violations of Sec. 227 of the Companies Act on the part of the Auditors of the Bank relating to branch audit, advances to Ketan Parekh group and Bharat Shah group, reasons for increase in NPAs, etc. for which the Auditors have been asked to furnish their comments.

5.153 According to Shri Ramesh Gelli, Ex-Chairman of the GTB, there had been substantial financing extended to Ketan Parekh Group of Companies and the Bank had no bad experience on this account since 1996. Since he was a major market player who had a turnover of about Rs. 115,000 crore in the year 2000-2001, the Bank was also deriving substantial benefits. RBI had also confirmed that the transaction turnover of KP group was Rs.1,26,726 crore for the same period. The Bank had about 260 broker accounts and depending upon the size and volume of business, the Bank had different limits for different brokers. It was accepted by him that the Bank did advance Rs. 250 crore to Ketan Parekh Group by way of loans and advances but he did not accept that it was in violation of the exposure norms of the RBI. The Committee were informed that in the entire episode, the Bank was likely to suffer an estimated loss of Rs. 128 crore on account of exposure to capital markets. Regarding corporate loans given by the Bank to the Zee Group, the Ex-Chairman of GTB submitted that the Zee Group was interested in taking corporate loans and it was given to them on the basis of detailed appraisal. The Bank was keen to get their business because the company had a networth of Rs. 4000 crore besides having a strong balance sheet and good income and profits.

5.154 It was further stated that the purpose for which the loan is taken is generally asked for by the Bank but if somebody is trying to make strategic acquisition, then he submits the details at the time of release of loans or after availing it. When it came to the notice of the Bank that the Zee had diverted the funds, an internal inquiry was ordered by the Bank as to whether there were any deviations or any lapses in terms of releasing the amount to Zee.

5.155 In respect of 9 banks for which RBI has provided information for the year 2000-01, it has been noted that similar observations on NPA variation and profit deviation, have been made by RBI in respect of all these banks. Further it is seen that NPA variance and profit variance is even much higher than GTB.

5.156 The Committee note that during the year 2000, the Global Trust Bank's exposure to the Capital Market by way of advances against shares and guarantees issued on behalf of the brokers was relatively higher and the Bank had a very high exposure to a particular stock broker. However, there were no violations of any prudential norms. It exceeded the minimum limit prescribed by the Board of the Bank, each of which was ratified by the Board. Subsequently the Bank brought down the same gradually. It was done only with the intervention of the RBI. RBI advised the ex-CMD to step down and accordingly Shri Ramesh Gelli relinquished his position on 12.4.2001. The RBI subsequently issued a show cause notice in May 2001, followed by a letter of displeasure. At the industry level, it is noted that UTI Bank has also exceeded the relatively high ceilings fixed by the Board and RBI after a scrutiny has expressed displeasure. There were also other banks who had significant exposure to capital market namely, HDFC Bank, Bank of Punjab, Centurion Bank and Bank of Madura (since merged with ICICI Bank). Also, three Banks, viz., Karnataka Bank, Bank of America and Development Credit Bank, had exceeded the 5% limit of investments in shares, etc. as of 31.1.2000.

5.157 The Committee also note that the guidelines issued by the RBI in November, 2000 had provided that a bank's exposure to the capital market by way of investment in shares, convertible debentures and units of mutual funds (other than debt funds) should not exceed 5% of the bank's domestic advances as on March 31, of the previous year. It was not considered necessary to prescribe an overall ceiling for advances against shares and issue of guarantees on the ground that the shares are taken as security and are subject to market discipline. The decision in this regard was left on the Boards of the individual banks. It was only recently in May, 2001 when fresh guidelines on the subject have since been issued by RBI and the Bank's exposure to capital market has been further regulated. The Committee is of the view that RBI should have been proactive in prescribing exposure limits to brokers, particularly after having done so in terms of exposure to investments in shares, etc. and IPO financing. Additionally, RBI should periodically monitor exposure of banks to sensitive sectors.

5.158 Cases have also reportedly been filed before the Debt Recovery Tribunal for recovery. The Committee were also informed by the RBI that the diversion of funds is not a specific violation under the Banking Regulation Act.

5.159 In view of the foregoing the Committee recommend the following:—

- (i) Action for recovery of the outstanding advances which have been diverted and the other advances which have now been categorized as NPAs be expedited.
- (ii) In case there is any dereliction of duty on the part of the Bank Auditors, the same may be referred to the Institute of Chartered Accountants of India for further enquiry and appropriate action.
- (iii) Even though there were no breach of regulations, it was observed that certain loans were sanctioned without comprehensive evaluation and therefore, the bank must ensure that proper credit appraisal and monitoring system is in place.
- (iv) The procedural working of the banks must be strengthened and the RBI must ensure that the rectification, if any, takes place in a time bound manner.
- (v) In the immediate aftermath of the Stock Market crash, RBI focused on one new private bank although other private banks also had large exposure to the capital market including some who had exceeded RBI limits. Now that substantial information is available about all the banks concerned, the Committee recommend RBI undertake a through review and process matters relating to all concerned in a uniform and consistent manner.

## Bank of India

5.160 The Stock Exchange branch of Bank of India, Mumbai is the prime banker to the Bombay Stock Exchange (BSE) and most of the broker clients have accounts with it for settlement purpose. The daily volume of business turnover is very high and large volume transactions take place in view of the activity of the BSE. The brokers had frequently approached the branch for immediate credit against Bankers' cheques/Pay Orders issued by other banks to settle their obligations with stock exchanges. Many times, it involved purchase/discounting of Bankers' cheques/Pay Orders of locally situated banks which were clearing members. Since Pay Orders are considered as cash equivalent, the branch discounted the Pay Orders and collected the proceeds of the same in the normal process of clearing. Till October 2000, Bankers' Cheques / Pay Orders issued by commercial banks only were purchased/discounted by the branch. However, from November, 2000 it started discounting Bankers' Cheques/Pay Orders issued by Scheduled Urban Co-operative Banks also. The level of transactions under the Pay Order discounting facility increased substantially and it was more or less a regular feature in the accounts of the Ketan Parekh (KP) group from around January 2001.

5.161 Three companies belonging to Ketan Parekh(KP) Group viz. Panther Investrade Ltd. (30.5.95) Panther Fincap & Management Services Ltd. (5.6.95) and Classic Credit Ltd. (12.4.99) had been maintaining current accounts with Bank of India, Stock Exchange branch from the dates as indicated in parentheses against their names. These companies, however, did not enjoy any credit facilities with the branch. However, for business considerations, Pay Orders of other banks were regularly purchased/discounted in these accounts. The branch purchased as many as 1504 Bankers' cheques/Pay Orders for Rs. 6550.76 crore including 251 Pay Orders (all of them in favour of the three KP group companies) involving Rs. 4214.29 crore issued by Madhavpura Mercantile Co-operating Bank Ltd. (MMCB) between 01 January and 31.3.2001. The branch had discounted 6 Pay Orders for Rs. 62 crore on 8.3.2001 and presented them in MICR clearing on 9.3.2001 *i.e* the following working day. Similarly, it discounted 7 more banker's cheques of MMCB for Rs. 75 crore on 9.3.2001 and presented them for clearing 12.3.2001(10 & 11 being holidays) which was again the following working day. All the thirteen Pay Orders discounted on 8th and 9th March, 2001 were credited to the three current accounts mentioned above held in the names of three companies belonging to KP group.

5.162 MNCBL, a scheduled Urban Co-Operative Bank, is a direct member of the Brihan-Mumabi Bankers' Clearing House (BBCH). The conduct of the account of MNCBL was satisfactory till 9.3.2001. However, MNCBL did not have adequate funds in its account with RBI (Mumbai) on 12 March, 2001 to meet its clearing liabilities aggregating Rs.137 crore *i.e* the aggregate value of the thirteen Pay Orders discounted by the Stock Exchange Branch, Bank of India on 8 and 9 March, 2001 and presented for clearing on the 9 and 12 March, 2001 (10 and 11 holidays). The officials of MNCBL were contacted immediately by RBI after the position became clear (at about 4.00 p.m. on 12.3.2001) and asked to fund their account, which they could not arrange. Officials of Bank of India were also contacted at this stage (at about 8.00 p.m. on 12.3.2001) and apprised of the status. They were informed that MNCBL was not in a position to meet its clearing liabilities. At about 9.30 P.M., MNCB returned six instruments worth Rs. 62 crore presented on them by the Bank of India in the MICR clearing of 9.3.2001 which had not been included in the return clearing.

5.163 The special scrutiny subsequently conducted by RBI revealed that MNCBL had issued the Pay Orders in question without adequate backing of funds and therefore could not meet the clearing liabilities.

5.164 Since the Clearing House does not accept any liability on behalf of its members (as per rule 1(c) of Clearing House Regulations), the President of the Clearing House invoked

rule 11 of the 'Uniform Regulations and Rules for Bankers' Clearing Houses' (URR) with effect from the MICR clearing of 9.3.2001, as the functions of the Clearing Houses are governed by the URR. (Rule No.11 of URR—In the event of a member bank defaulting in meeting its liabilities on account of clearing at the settling time, the defaulting bank will be called upon to return immediately all the instruments drawn on itself and its sub-members, to the members who presented the instruments and the clearing settlement shall be effected as if the said instruments did not participate in the clearing). The position was intimated to all the members of the clearing house the following morning *i.e.* 12.3.2001 (10th & 11th being holidays). In effect, invoking of Rule 11 of URR involved unwinding of clearing operations with regard to MMCB, *i.e.* conducting the clearing settlements as if MMCB had not participated in the settlement at all. The MMCB should have accordingly, returned the unpaid instruments but they took their own time to return the instruments. Subsequently, Regulation 13(d) was also invoked in terms of which MMCB ceased to be a member of the Clearing House with effect from 13.3.2001.

5.165 The scrutiny also revealed certain lapses in the area of systems and internal control. Between 1.1.2001 and 31.3.2001 the branch had discounted 251 bankers' cheques aggregating Rs. 4214.39 crore issued by MMCB, all of which pertained to Ketan Parekh group companies without setting any exposure limits for customer/counter-party bank. The discounting of high value pay orders/bankers' cheques was resorted to on a large scale by the branch after the new AGM, Shri U.H. Somaiya took over in November, 2000. Six instruments for Rs.62 crore and 7 instruments for Rs.75 crore were presented for clearing by the bank one day after discounting them, instead of the same day as is the usual practice for high-value instruments. The branch had not been subjected to concurrent audit after October 2000 and the last internal audit was conducted in November 1999.

5.166 In reply to the question regarding the total losses suffered by the Bank of India due to Madhavpura scam, the RBI had informed that as reported by the Bank of India on 25.7.2001 it has suffered a net loss of Rs.129.66 crore after adjusting the credit balances available in various accounts of Ketan Parekh group. The Committee were informed that the management of the Bank has suspended two officials, one Assistant general Manager and the Accountant of its Stock Exchange branch. They were also informed that suspension of the accountant has since been revoked by the management after it came to their notice on investigation that he was not involved and an internal investigation covering the staff accountability aspect is in progress.

5.167 While responding to the query as to why only one person has been singled out by the Bank for initiating disciplinary action, the representative of the Reserve Bank of India stated during the course of evidence, that "it is pertinent to mention that Shri U.H. Somaiya, AGM, who had been charge sheeted earlier and awarded punishment under CVC instructions took over charge of the branch in November, 2001, and allowed discounting of high value Pay Orders issued by MMCB in favour of KP Group of companies. That is one point. Otherwise, we are not saying that he alone is responsible." On being pointed out by the Committee that the Branch Manager had indulged in indiscretion and there cannot be any element of suspicion that he was colluding with Shri Ketan Parekh, the CMD stated, "That is precisely the reason that he was suspended." He also agreed with the observation of the Committee that there were press reports indicating that Ketan Parekh and his associates had run out of financial solvency and that should have alerted the zonal manager.

5.168 In order to ascertain the facts the Committee also took oral evidence of the representatives of the Bank of India. When asked to state as to why there was no system of concurrent audit in the Bank, the CMD, Bank of India confirmed to the Committee during the evidence that during the period October, 2000 to June, 2001 the BSE Branch of Bank of India

had stopped the concurrent audit on account of resignation of the Concurrent Auditor, which was contrary to the RBI instructions. Thereafter, the Zonal Manager took time to post another officer and he even did not inform the Head Office about the lapse in this regard. On being asked as to why the credentials of Mr. Somaiya were not checked up by the management before transferring him to the sensitive post of Stock holding Branch of the Bank, the CMD stated that he was only charge sheeted for minor penalty and that no loss had been caused to the bank. Further, the reason that he was posted in the branch was that earlier he was in-charge of the Shareholding Corporation and was handling the clearing operations on behalf of the Bombay Stock Exchange. Since he had the basic experience, he was thought fit for the post. He also informed the committee that his name was recommended by the zonal manager of the Mumbai South Zone under whom the Bombay Stock Exchange falls. However, the representative of the RBI on being confronted with the same question stated:

“There are lapses on the part of the management in the entire handling of these payment orders. One is putting a person in charge of these transactions after he was punished. What we want to say is, such a person should not have been put in the sensitive branch where thousands of crore of payment orders were handled.”

5.169 According to the CMD of the BOI, the discounting of MMCB pay orders was done as per the rules of the Bank and were within the delegated powers. The Branch manager had not exceeded his authority at any point of time. Further, there was no reason to believe that the Madhavpura Cooperative Bank, a scheduled bank, which was also incidentally a clearing bank for many cooperative banks, would be declared a defaulter overnight. In the entire transactions of the past, there was almost an amount of Rs.4900 crore which was discounted; and every time it got paid. Before paying the pay orders, the genuineness of pay orders was verified by the Branch Manager himself. He had enquired with the Madhavpura Branch and it was confirmed that these were the pay orders issued by them and that when presented, they would be paid. He opined that even had there been a concurrent auditor in place, he would not have reported anything unusual. The risk involved was not credit risk but a settlement risk which the Bank took for earning commission on discounting charges, as no pay order can be issued without receiving the full value. It was also brought to the notice of the Committee that as per the policy of the Bank there was no limit on the amount involved in discounting of the bankers cheques and discretionary powers were given to the Branch Managers to discount 'A' class bankers cheques as well as bankers' cheques from scheduled banks.

5.170 Giving his views on the observation of RBI that there was a failure of internal control and risk management in the Bank, the CMD of the Bank of India stated:-

“Here what has happened is a pure settlement risk. The pay orders which were considered as equivalent to cash and which were taken and discounted got bounced because the Madhavpura Branch could not meet the liability. They were declared as a defaulter.”

5.171 On being asked by the Committee about the subsequent corrective measures taken by the Bank to prevent recurrence of such incidents, the CMD submitted that :—

“..... Subsequent to this, as a knee jerk reaction, almost all the banks, including ours, stopped discounting Pay Orders of any cooperative bank. After that, so far as the Demand Drafts of any bank are concerned, we have fixed counter party limit, prudential limit, giving permission to the Branch Managers. If he is the Manager of a small branch, for Demand Drafts, he can go up to Rs. one lakh, if it is a large branch, the Branch Manager concerned can go upto Rs. 10 lakh and full powers are available only with the Chairman, Executive Director and General Managers. So, like that, we have fixed prudential

norms now. Previously it was not there because such incidents never happened. We have become wiser by fixing these norms. Now this will only create a problem in the business. After all, anybody coming with a Demand Draft and asking for immediate facilities will have to wait for some period till the clearing takes place. Normally, returns come only on the third day in the Indian context and we give credit only on the fourth day. Again, whether such things can be avoided, I would like to say that today due to lack of computerisation, on a real time basis, one will not be able to know what will be the liability or outstanding of any particular instrument all over the country. It is very difficult to say that. So, an element of risk will always be there. We have appropriate policy for credit risk, we have now taken a decision to fix prudential norms for different category of persons.”

5.172 In respect of the action taken by the Bank of India in this case, the Committee were further informed that the Bank had filed a criminal case against Shri Ketan Parekh as well as MMCB with the CBI. Further, for recovery of the money, the Bank had filed a civil suit in the Debt Recovery Tribunal. Regarding delay in filing the complaint with the CBI against Shri Ketan Parekh, which was filed on 30.3.2001, the Bank representative submitted that initially they wanted to recover the amount by persuasion. The Committee also note that according to the representatives of the Bank of India, when their investigators went and asked the MMCB officials as to how they issued the pay orders when the funds were not available with them and whether Ketan Parekh had any limits with them, they said “As and when KP wanted the Pay Orders, we used to get a directive from the Chairman of the MMCB to issue draft”. The Bank of India investigations have revealed that the Chairman of the MMCB was directly instructing all Branch Managers to do such things and it was established beyond doubt that he was involved in all this. The CMD had also informed the Committee during the course of evidence that the Accountant who had earlier been suspended was reinstated because it was found that it was an unfair suspension and he was not involved. Actually he had advised the Branch Manager that they should be more cautious in discounting the pay orders.

5.173 On being asked as to what corrective measures had been taken by the Reserve Bank of India with a view to ensure that such irregularities do not take place, the RBI in a subsequent note submitted to the Committee informed that they had *vide* letter dated 19.7.2001, instructed the Bank as under :-

- (a) The Bank was advised to reintroduce concurrent audit in sensitive areas of bank’s operations;
- (b) It was advised to improve risk management systems in the bank by setting exposure limits against (counter-party) banks participating in clearing house operations in accordance with “guidelines on risk management systems in banks” contained in our circular dated 7.10.1999 which details all types of inter-bank exposures including credit risk arising out of settlement of inter-bank transactions. Credit risk arising out of permitting drawals against uncleared effects including Bankers’ Cheques and Pay Orders should be reckoned while fixing inter-bank limits since exposure to the payment system (including clearing house) exposes the bank to credit, liquidity and systemic risk. The bank was further advised to adopt an appropriate mechanism to evaluate risk profile of counter-party banks and fix appropriate limits on the basis of risk perception on them;
- (c) The bank was also advised to evolve a suitable framework to provide a centralised overview on the aggregate exposure to other banks. Banks like corporate clients should also be rated on the basis of their credit quality. Bank-wise exposure limits could be set on the basis of assessment of financial performance, operating efficiency and management quality, etc. Half-yearly/Annual reviews should be undertaken by the bank.

5.174 The Committee take a serious note that the Bank of India did not follow laid down rules, procedures and norms. The committee specifically note that the Bank of India :—

- (a) delegated unlimited power to the Branch Managers/officials of the Bank in respect of discounting the pay orders without weighing either the financial standings/status of the counter party Bank or the track record of the client. While observing this, it is recognized that though the delegated powers stood the test of time over a period of about 15 years, the Bank could have revised this and that the Reserve Bank of India could not detect the unlimited powers so given by the bank, during the Annual Financial Inspections conducted by it for so many years and further that the Board of the Bank which included representatives of Government and RBI had approved these delegations;
- (b) did not prescribe any system of reporting these transactions by the Branch to the controlling office through an omission with the result that the latter remained totally oblivious of what transpired down below;
- (c) despite detailed instructions issued by the RBI, the Bank had discontinued concurrent audit of its Mumbai Stock Exchange Branch after October, 2000 and the same was not re-introduced till June, 2001;
- (d) no regular audit of the branch took place after November, 1999;
- (e) no effort was made to exercise control and to put the risk management measures in place and guidelines issued by the RBI on the subject were flouted with impunity. While observing this, it is recognized that Bank of India had in place risk management measures comparable to other peer banks in the industry and that it did not have a counter-party bank exposure limit for discounting of pay orders, just as many other peer banks;
- (f) although the Mumbai Stock Exchange branch was handling large volumes of business, mostly sensitive in nature being related to capital market transactions, an officer (Shri U.H. Somaiya) with a tainted record was posted as AGM in this branch during November, 2000 who in turn allowed large scale discounting of high value pay-orders issued particularly in favour of Ketan Parekh group of companies by MMCBL and ultimately this resulted in a big pecuniary loss to the Bank to the tune of Rs.129.66 crore as on 25.7.2001. The fact that while discounting a large number of pay orders, he even did not think it prudent to heed the advice tendered by the Accountant of the branch and also ignored the reports appearing at the point of time, in different newspapers regarding the financial problems being faced by Shri Ketan Parekh, puts his role under suspicion. While observing this, it is recognised that the punishment given to Shri U.H. Somaiya for lapse committed by him earlier in the Bank was a minor one and that it did not bar him in being considered for the post of AGM of the Stock Exchange Branch as per internal rules of the Bank and the Bank had posted him as AGM of the Branch having regard to his exposure as Managing Director of Bank of India Shareholding Corporation. In this connection, it should be necessary to carry out further inquiry regarding financial benefits reaped by Shri U.H. Somaiya, his present wealth and the mode of acquisition.
- (g) The Committee is unhappy that the management did not care to hold all those responsible who were at the helm of affairs and were more responsible to ensure that the Bank functioned on prudent business principles and directions of the apex bank are followed stringently. No action, for instance, was taken against the Zonal Manager for his failure to alert the Head Office. Concurrent auditor was also not appointed for months together. For this lapse there is a case for proceeding against the Zonal Manager.

5.175 The Committee note that though as subsequent corrective measures the Bank has now stopped discounting pay-orders of any cooperative bank and have fixed counter-party limits/prudential limits for different categories of persons in the case of demand drafts, the major problem of overcoming the settlement risk which is reported to be the main cause behind this huge loss still remains to be addressed to by Reserve Bank of India and the Indian Bankers' Association. The Committee, therefore, recommend the following action"—

- (a) Technology be improved with a view to ensuring that counter-party risk gets minimized through the introduction of real time gross settlement system, so that the whole payment and settlement system gets integrated. With a view to ensuring that such failures do not take place in future this must be accorded top priority;
- (b) Disciplinary action be taken against all those who were supposed to exercise due diligence in the discharge of their duties and have failed to do so. Investigations be made to find out if Shri Somaiya or any other official of the Bank had colluded with Shri Ketan Parekh and in case it is proved, criminal proceedings be launched against all those who are responsible for causing wrongful loss to the Bank;
- (c) Efforts for recovering the balance amount of Rs.129.66 crore be speeded up.

#### **Nedungadi Bank Ltd.**

5.176 The Nedungadi Bank Ltd. came into existence in June, 1899 in Calicut City, with a modest aggregate working funds of Rs. 19,000 as a family concern of Rai Bahadur T.M. Appu Nedungadi. On 29.5.1913, the family concern was converted as a public limited company and was registered under Companies Act, 1913 with head office at Calicut (Kerala). The Bank has 172 branches and eight extension counters, 5 Regional Offices and a Corporate Office at Calicut. The principal activities of the bank include acceptance of deposits, lending, remittance, foreign exchange business, integrated treasury, cash management, services of quick collection of cheques for corporate clients, credit card business, merchant banking activities etc.

5.177 The Board of Directors of the Nedungadi Bank Ltd. approved a scheme of arbitrage in September, 1999, which envisaged purchase and sale of shares taking advantage of the price differential between NSE and BSE and other Stock Exchanges. The Board of the Bank included the former President of the BSE, Shri M.G. Damani, who was instrumental in devising the scheme, and Shri C.V. Nair, a former Executive Director of RBI. The Board delegated powers to the Chairman and General Manager to purchase and sell shares to the extent of Rs. 5 crore and 2 crore respectively through approved brokers. It was envisaged in the scheme that there would be simultaneous purchase and sale of shares to take riskless arbitrage profit and that the bank will not keep any open position of unsold shares. The broker would pass on the arbitrage gains fully to the Bank and would get compensated by way of commission/brokerage on the deals. Though the RBI had issued guidelines that banks will not resort to short selling, there were no express guidelines prohibiting arbitrage.

5.178 The Committee wanted to find out as to how such a scheme, was resorted to by the Bank even when the nominee of the RBI happened to be on the Board and also whether such malpractices never came to their notice during the course of the inspections. The RBI in their written replies submitted that when the Bank was inspected with reference to the financial position of the Bank as on 30.9.1999, (inspection was carried out between 5.3.2000 to 5.5.2000 and the report finalised on 6.6.2000), it was observed that (i) though it was envisaged in the scheme that there would be simultaneous purchase and sale of shares to take riskless arbitrage profit and the Bank will not keep open position of unsold shares, yet the Bank was not selling the shares purchased immediately contrary to the scheme. (ii) It was also observed that the

value of the transactions on certain days was in excess of the powers vested in the Chairman and ratification of the Board was also not sought. (iii) The holdings of shares purchased for trading and held unsold on certain dates were in excess of the limits worked out on the basis of 5% incremental deposits for 1998-99. (iv) The Bank had decided to undertake trading in shares through three broking firms which were connected with some major shareholders of the bank. The approved brokers were: The Harvest Deal Securities Ltd., Member NSE, The First Custodian Fund (India) Ltd., Member, NSE, and Srikant G. Mantri (v) Although the Senior Manager of the Fort Mumbai Branch was not vested with any powers for purchase and sale of shares, he indulged in such activities in anticipation of Head Office confirmation. The transactions undertaken by him were not ratified/confirmed by Head Office and (vi) The Mumbai, Fort Branch, where the transactions were undertaken, was not subjected to concurrent audit.

5.179 The irregularities pointed out in this Inspection Report were discussed with the Chairman of the Bank on 8.8.2000. In view of the Chairman's submission that the scheme had been discontinued from 1.4.2000, no further action was proposed. However, after the arbitrage operations had been discontinued and RBI had decided against further action, the Thiruvananthapuram Regional Office of RBI learnt that perhaps serious irregularities had happened which the Chairman had not reported. It was also learnt that one of the Director was connected to the three broking firms involved in the arbitrage, namely, Shri Banthia who was later on co-opted on the Board of the Bank in December, 2000. It was also learnt that the share transactions were put through three broking firms connected with the Directors of the Bank and the sale proceeds of the shares had not been received by the Bank. Though earlier Shri Banthia himself was not on the Board, as per SEBI's Investigative Report he had two nominees namely, Shri M.G. Damani and Shri Vaidya serving on the Board.

5.180 In view of this revelation, an inspection of the Bank was taken up on 29.1.2001 with reference to the position as on 31.12.2000 along with a special scrutiny of the bank's Fort, Mumbai Branch. The scrutiny confirmed that there were serious deviations in the implementation of the scheme approved by the Board. The total turnover of the trading of shares with the three broking firms had aggregated to Rs. 1352.54 crore. The transactions with other approved brokers were insignificant at Rs. 0.26 crore. Besides undertaking arbitrage operations, the bank was holding the unsold shares and the broker firms had outstanding dues to the bank on account of the shares acquired. The inspection further revealed that as at the end of March, 2000 an amount of Rs 94.52 crore had remained due from the three broking firms on account of such irregular transactions. In order to hide the outstanding amount, instead of recognizing them as advances to the broker, the Bank had chosen to show the above dues under "other assets". Besides, the Chairman had failed to report this position to the Board till March 2001. While Rs 73.42 crore has been collected subsequently, an amount of Rs 21.10 crore still remains overdue.

5.181 The inspection also revealed that Shri R.K. Banthia had substantial shareholding in the bank either directly or through his family members or associated firms/companies. Shri Banthia was also closely connected with the three broking firms involved in these transactions. He is the Managing Director of the Harvest Deal Securities Ltd. in which Smt. Saroj Banthia (wife) and Shri Manish Banthia (son) are also Directors. Further, in the First Custodian Fund (India) Ltd. Shri Surender Kumar Banthia (brother) is the Chairman and his son is the Director. Shri Srikant G. Mantri, a broker on the BSE, held 10.51% of the Bank's paid up capital and also enjoyed an overdraft limit of Rs 5 crore and a bank guarantee limit of Rs. 6 crore from the Bank. Shri Sushil Mantri, Executive Director of the First Custodian Fund (India) Ltd. is a close relative of Srikant G Mantri, who is a close associate of Shri R.K. Banthia. The Company enjoyed overdraft

and bank guarantee limits of Rs. 5 crore each from the bank. Moreover, all the three broking firms functioned from the same premises and had common phone and fax connections. These are clear indications that all these three firms were closely connected and directly/indirectly controlled by Shri R.K. Banthia.

5.182 It also came to the notice that the Harvest Deal Securities Ltd. of which Shri R.K.Banthia is the Managing Director, also owed an amount of Rs. 1.10 crore to the Bank by way of interest payable on the late delivery as on the date of inspection. The other two associate companies/firms owed Rs 7.53 crore to the Bank under the credit facilities enjoyed by them and also under the same arbitrage transactions. The financing of the brokers in this manner led to peak exposure of Rs 94.62 crore to the three brokers, when the scheme was suspended. Out of this, an amount of Rs 73.42 crore was paid to the Bank at various stages over a period of one year, leaving a balance of Rs 21.10 crore payable by Srikant G.Mantri, as on 31/3/2000. The firms also owe an amount of Rs 8.72 crore towards interest charges for delayed payment of sale proceeds. The dues have not been cleared till date. The value of the underlying shares has declined and the dues have become largely unsecured.

5.183 It has further been stated that since the irregularities brought out by the inspection indicated serious dereliction of duties on the part of the Chairman, a show cause notice was issued to him on 11.4.2001 asking him to show cause as to why an order should not be made removing him from office. Shri Murti submitted his reply *vide* his letter dated 20.4.2001 and chose to resign from the Bank simultaneously. As desired by him a personal hearing was granted to him on 4.5.2001 by Shri Khetrapaul, ED-in-charge of Bank Supervisions, RBI. As his written and oral submissions were found unsatisfactory, final orders dismissing him from the Chairmanship of the bank with immediate effect and also debarring him from taking part in the management of any banking company either 'directly' or 'indirectly' for a period of five years, were issued to him on 4.5.2001 under section 36AA of the Banking Regulation Act, 1949. A complaint has also been filed on 14.5.2001 in the court of the Judicial First Class Magistrate, Calicut, under section 46 of the Banking Regulation Act 1949 read with section 190(1) of the Criminal Procedure Code against Shri Moorthy. Besides, in view of the reported role played by the Director Shri R.K.Banthia, a notice was issued on 27.4.2001 asking him to show cause within a period of two weeks from the date of receipt thereof as to why an order should not be made removing him from office of the Director of the Bank. He has, however, resigned from the Board. SEBI has also been informed about the default of Rs 21.10 crore by Srikant G. Mantri and also about the irregularities of transactions and the role played by the three broking firms. The Bank has also been advised to consider filing a civil suit as well as lodge a claim with BSE for recovering an amount of Rs 21.10 crore. The Bank has also been advised to inform RBI about recovery efforts as well as other NPAs on a monthly basis.

5.184 From the latest reply received from SEBI, the Committee were informed that SEBI had initiated investigations into the dealings of three broking firms namely Harvest Deal Securities Ltd., a Member of BSE, Srikant G. Mantri, Member of BSE and the First Custodian Fund (I) Ltd., a Member of NSE with Nedungadi Bank Ltd. The details/documents/records have been collected from the brokers. Also additional information regarding the transactions have recently been received from RBI. Details from Nedungadi Bank are yet to be submitted by them. Analysis and scrutiny of these details/documents/records as well as examination of the key persons on oath including Shri R.K. Banthia, Shri Srikant G. Mantri, Shri Sushil G. Mantri etc. are under progress. SEBI has not prohibited the broker Shri R.K. Banthia (Director of Harvestdeal Securities Ltd.) from undertaking broking activities so far, as the investigations are in the final stages and is likely to be completed shortly. SEBI has, however, informed that action would be considered on completion of investigations and after following due process of law.

5.185 With a view to ensuring that such irregularities do not recur, the RBI has instructed all the Commercial Banks vide circular No DBOD.BP.BC.119/21.04.137/2000-01 11.5.2001 that they should not undertake arbitrage operations themselves or extend credit facilities directly or indirectly to stock brokers for arbitrage operations in Stock Exchanges.

5.186 The Committee also took oral evidence of the representatives of the Bank on 25.9.2001. Giving a brief summary of the case, the present Chairman Shri J.R. Prabhu of the Bank stated as under:-

"The Bank, way back in September 1999, evolved a scheme for arbitrage and trading of shares. The intention was that the shares will be purchased and on the very day it would be sold. For undertaking these transactions, the work was entrusted by the bank to the brokers. One was Shri Mantri and the other was Banthia. They were engaged in carrying out these transactions. Now these transactions continued from September, 1999 to March, 2000. At the end of March, 2000 it was found that about Rs 94 crore and odd were yet to be recovered from these brokers by the Bank. Subsequently the amounts were received, a sum of about Rs 21 crore and odd is still outstanding to be recovered from these brokers—Shri Mantri and others. Strictly speaking, I should say that the instructions issued by the Reserve Bank of India at the relevant point of time were that the investments should not exceed more than 5% of the incremental deposits. Here, the bank probably took a stand that it does not come within the purview of that regulation because shares were immediately purchased and were required to be sold. This was what had happened. A sum of Rs. 21 crore is yet to be received. According to the broker's note, it has been indicated that if any dispute is there in regard to these transactions between the Bank and them, it should be referred to arbitration. Simultaneously, Shri Mantri the broker, has also filed a suit against the Bank claiming that about a crore of rupees is due to him by the bank. This suit is also pending. This was what happened as far as these transactions, in brief, are concerned."

5.187 He further stated that when in March, 2000 RBI carried out the inspection, it was brought out in the inspection report that the Bank had absolutely no control whatsoever on these operations in the sense that what is the scrip in which the brokers could invest or when they could invest or how much could be invested and all was left to the brokers themselves. He also added :

"The other aspect is that these brokers—Shri Banthia and Shri Mantri—have also been granted advances against the shares by the Bank sometime in the month of November, 1998. There also a sum of about Rs. 11 crore is still outstanding. If the shares are sold, the bank will be put to a substantial loss—may be around Rs 7 crore. Some of these shares are not quoted and they cannot be sold in the market. Therefore, in short, a sum of about Rs. 34 crore is still outstanding from the brokers and due to be recovered from them. Incidentally these brokers have also shareholdings in the bank. Shri Banthia, Shri Mantri and the associated concerns are having shareholdings in the Bank."

5.188 When asked as to who were the Directors on the Board when the scheme was approved in September 1999, the Chairman informed that "When the scheme was approved, the two broker-Directors were Shri Vaidya and Shri Damani." When asked to clarify as to when did Shri Banthia come to the Board, the witness informed that it was in the month of December, 2000. When further asked as to whether any criminal case was also filed against the Broker Directors the witness replied in the negative. When asked to state that whether when the scheme was approved, the nominee of the RBI objected to the same, the witness replied, "He has reported it to the Reserve Bank of India, but I have not seen any dissent in writing". While elaborating on this he further added, "What happened was that the scheme was evolved in

the month of September, 1999. Then, the nominee of the RBI on the Board also objected to it saying that this was not in conformity with our regulations. Then the Bank wrote to the RBI seeking clarification and wanted to proceed further with the scheme. But before any reply could come from the RBI, the Bank went ahead entering into these sort of operations." On being asked whether the Bank informed the RBI in this regard, the witness stated that an application was made to RBI immediately after the Board meeting was over and after that RBI wanted certain clarifications before telling finally yes or no and the correspondence went on from October to February. When asked to state if the investments that have been made in the arbitrage business were exclusive of 5% limit, the witness stated, "Sir, as I said, RBI did not envisage that Bank could arbitrage at all. So there was no question of this being treated as approved type of transaction to my mind."

5.189 On being asked to state as to whether an amount of Rs. 94 crore which was due from brokers was shown under, "other assets", the witness stated, "It is exactly correct. In the balance sheet, in the year March, 2000, a sum of Rs. 94 crore, which was due from these brokers, was shown under, 'other assets'. As a result of it, there was a great jump in the total other assets to the extent of more than Rs. 100 crore while in the previous year, it was Rs. 8 or 9 crore.' On being asked as to what was the total turnover in respect of these brokers *vis-a-vis* other brokers during the relevant period, the witness informed that it came to about Rs. 1300 crore, whereas in the case of others it was just negligible. On being asked to state whether it was a fact that that loans and advances aggregating to substantial amounts had been sanctioned by the Chairman to companies and firms in which relatives of Directors of the bank were interested, the witness stated, "Yes, there were some advances sanctioned to some of these concerns in which directly or indirectly the Directors were interested. There have been large number of such sanctions and as a result of it, today, I am sorry to say that, the Bank is saddled with a very high level of non-performing assets."

5.190 The Committee also took oral evidence of the ex-chairman Shri Moorthi of this Bank. During his deposition he stated as under:-

"Arbitrage transactions are done by all the banks, especially, in foreign exchange and money markets, to take advantage of the price difference in different markets. The entire product was discussed in detail in the Board of Directors of the Bank, which included other eminent personalities like an RBI nominated Director, a chartered accountant, a legal luminary and also an ex-ED of RBI. The product detail, including the names of the brokers to be engaged, were sent to the RBI and their queries on the product were also clarified in writing. Unfortunately, in the second half of March, 2000, the senior Manager Investment Cell at Mumbai, had made certain unauthorized arbitrage transactions to the extent of Rs 94.52 crore. This serious lapse was noticed in the first week of May, 2000 as a reconciliation difference."

5.191 In order to protect and safeguard the interest of small investors, immediate action was taken by him in full confidentiality to recover the dues and he succeeded in collecting Rs.73.42 crore. The reasons for entering into arbitrage business were primarily to find new avenues for earning income for the Bank keeping in view the fact that the capital market was in a booming condition at that point of time. While further elaborating on the reasons for entering this business, he stated; "This was the first Bank in the private sector and we wanted to show good results in the centenary year. So this proposal was discussed in the Board threadbare. Shri Damani was an expert from the Stock Exchange. He explained to us how it could be taken advantage of for about two and half hours. We were given to understand—I am sorry, we do not have evidence on that—that other banks were also doing arbitrage in foreign exchange and even in call money market; so, every day. Money was borrowed, lent and arbitrage and

the benefit was being taken. So, we were told that other Banks were doing it. There was no bar of RBI that we could not do it. I can categorically say that there was no bar because we did this in September, 1999 and there was an official communication that banks should not be doing arbitrage in May, 2001. So in September, 1999, when we went to the Board, there was no bar. Still we wrote a letter to the RBI giving the complete details. Subsequently, we got a letter from the RBI asking for certain clarifications. We had mentioned that they were the three brokers who would be doing it because it requires a lot of expertise and ordinary brokers could not do it. They had shares in the Bank. So it was known to the Board that we were entrusting this work to these three brokers and a reason for that. The reason was that they would only safeguard the interest of the Bank because they had got about 45-50% shares though officially it was only 20%. So they could not afford to allow the bank to go into losses." He further informed the Committee that the scheme was approved by the Board on 26.9.1999 and the bank had sent a letter to the RBI on 14 October, 1999 giving the details about the scheme. At that time there was no bar on the bank to do arbitrage. The RBI had sought certain clarifications on 6.11.1999, regarding the credit limit sanctioned by the bank to the brokers and the current status of such advances and whether any of the Directors of the bank were having any connection or interest in any of the broking firms, and if so whether the provision of Section 20 would be attracted. The Bank had replied to this on November, 1999, giving the names of the brokers through whom the business was being done and also the credit limits sanctioned. The Trivandrum and Mumbai office of RBI were fully informed of this. He further added that they did not get any objection at that time. However *vide* letter dated 16.2.2000 the RBI wanted to know as to how the Bank would ensure that no short selling takes place and somehow this letter was not replied to by the Bank. He also informed that all these transactions were reported to the Board every month starting from December, 1999 to March 2000. In response to the question if the Bank resorted to short selling, the witness stated, "We purchased and then only we sold. We did not do any short selling."

5.192 When the Committee enquired from the representative of RBI as to why no action was taken by them even when they were informed that such a scheme has been approved by the Board of the Bank, the representative while replying stated: "Sir, the Nedungadi Bank had made a reference to us that they wanted to start the scheme. It was never mentioned that they had already started the scheme and then they were making reference to us." He also confirmed that the nominee of RBI also did not record any note of dissent. When asked to state if such a scheme was in operation in other banks also, the RBI representative stated, "It was not to the notice of the RBI till that time. Subsequently when these terms were being coined in 2001, banks were told not to enter into arbitrage business." On being asked as to normally how much time is taken by RBI to approve a proposal, the witness stated, "When a reference is made to RBI, the onus lied on the Bank to come back to RBI if they wanted to implement the scheme." He also added that though the scheme was discussed in the first meeting of the Board, yet thereafter the Board was not kept apprised of the implementation of the scheme. While giving further information with regard to the instructions issued by RBI, he stated; "Instructions in this regard have been issued in 1992. It stipulates that no bank will enter into short selling. They cannot sell if they do not have the securities in position. That is precisely when this reference was made to the Reserve Bank of India in October 1999. In 16.2.2000 letter we had asked this question, instead of using the word arbitrage because it was not in vogue at that time, I am quoting from the letter, how the bank propose to ensure that there is no short selling as advised in our circular? The bank has not replied to that."

5.193 The RBI in their reply to question no. 1048 stated that barring GTB Ltd. and Nedungadi Bank Ltd., all the banks have reported that they have not provided any facility to brokers for arbitrage trading between November. 2000 and April 2001.

5.194 Reserve Bank of India in their subsequent note submitted to the Committee stated the following :

- (i) Smt. S. Valsala Devi, AGM was appointed as nominee Director on the Board of the Bank on 24.2.1999. After the Board approved the proposal, the Nominee Director submitted a note on the subject to the Thiruvananthapuram Regional office of RBI on 29th September, after the Board meeting, requesting Central office of the Department of Banking Operations and Development (DBOD) to examine and advise the Bank suitably in the matter. She informed in her note that though the scheme had been approved by the Board, she was not in a position to offer her comments in the matter and she had indicated to the Chairman that the matter needs further examination. The two matters which according to her needed further examination were (i) whether the bank could enter into such trading activity and (ii) whether entrusting the activity to brokers would tantamount to giving an advance to brokers.
- (ii) The Regional Office, in turn, forwarded the Nominee Director's note to DBOD, Central Office, Mumbai, for instructions under cover of their letter dated 6.10.1999.
- (iii) Based on the Regional Office letter, the Chairman of the Bank was advised telephonically on 14.10.1999 to forward details of the scheme to the RBI. The Chairman *vide* letter dated 14.10.1999, however, informed that the Bank had implemented the scheme on an experimental basis and earned a profit on such transactions and the entire transactions would be placed before the Board on a monthly basis. The Bank did not seek approval but instead, informed that the investment and trading in equity shares in the stock exchange was being done as per existing guidelines and norms.
- (iv) On further examination, the Regional Office was advised by DBOD on 2.11.1999 to ascertain from the Bank as to (i) credit limits sanctioned to the brokers, (ii) whether any of the directors of the bank was connected in any of these firms, and whether provisions of Section 20 of the Banking Regulation Act would be attracted.
- (v) The Regional Office, after ascertaining the position from the Bank sent the reply obtained from the Bank *vide* their letter dated 8.11.1999. The Bank had stated that none of the Directors had any interest in any of the broking firms and hence the transactions would not attract provisions of Section 20. They also furnished limits given to three brokers.
- (vi) The matter was re-examined and the Bank was advised on 16.2.2000 to furnish information on how it proposed to ensure that (i) there was no short selling and (ii) transactions entered into through individual brokers would not exceed 5% of the total transactions. A copy of this letter was endorsed to Regional Office and reminders were issued on 27.4.2000, 14.6.2000 and 26.7.2000 but no reply was received from the Bank. In between, the Chairman informed RBI orally that the operation under the scheme had been suspended from April, 2000 without assigning any reason.
- (vii) Although RBI had not placed any restrictions on banks to undertake arbitrage transactions, they are advised not to engage in short selling of securities and that the investment in shares is within the ceiling of 5% of the outstanding domestic credit.
- (viii) From the scrutiny of the related Board papers on arbitrage transactions it was revealed that the reports did not indicate details of losses incurred on account of these transactions, except in the memorandum of December, 1999 wherein the loss on account of trading in three securities was indicated which was within the limits approved by the Board in September. There were no details of the extent of individual transactions that were within the limits approved for CMD.

5.195 The Committee note that the management of the Nedungadi Bank embarked on a scheme of arbitration which envisaged purchase and sale of shares by taking advantage of price differential between NSE, BSE and other Exchanges through a set of three broking firms without adequate diligence on their part. All the three broking firms were closely connected with Shri R.K. Banthia which together held 22.19% of the paid up capital of the bank. This action of the management caused pecuniary loss to the Bank. According to the scheme, the shares were to be sold and purchased on the same day. This was not done with the result that at the end of March, 2000 it was found that about Rs 94.52 crore were outstanding from the brokers. After recovery, subsequently, an amount of Rs. 21.10 crore is still outstanding. This outstanding amount was surreptitiously shown under the head of 'other assets' in the balance sheet of the Bank and even the auditors failed to point out such a glaring discrepancy in the accounts. The Committee also note that contrary to all ethical practices, the brokers who had substantial stake in the Bank were instrumental in granting huge advances to their own kith and kin with the result that the Bank got saddled with huge non-performing assets.

5.196 In this respect the Reserve Bank of India did not take timely notice of this irregularity. When RBI was informed that the scheme had been implemented on experimental basis, instead of stopping the scheme immediately, the RBI took their time and did not take prompt decision. Even when the Board was informed of the arbitrage transactions, the RBI's nominee Director did not raise the question of suspending arbitrage transactions. Besides, from the record placed before the Committee they find that the representative of the RBI while deposing before the Committee, did not place the correct facts before them. All along, it was stated by him that the RBI was not informed about the implementation of the scheme and the matter was not placed by the Bank before the Board, whereas the facts placed on record before the Committee speak otherwise. The Committee take a serious note of this. After having examined the witnesses and going through the evidence placed before the Committee, they conclude that there was an attitude of total apathy on the part of the RBI with the result that funds were manipulated and misused by a few brokers who alone had a turnover of about Rs.1350 crore to their sole advantage during the relevant period.

5.197 The Committee note that though criminal proceedings have been filed against the ex-Chairman who has since been dismissed, but no such action has been taken either against the Directors or against the Senior Manager of the investment cell who is reported to be absconding. The Committee recommend:

- (a) Appropriate action should be initiated against Directors and senior manager of the Investment Cell for having committed a breach of trust and causing wrongful loss to the Bank.
- (b) Expeditious action be taken to recover the balance amount of loss to the tune of Rs. 21.10 crore caused to the Bank, from Shri R.K. Banthia, broker-Director, Shri Srikant G. Mantri, broker and Shri H. Ganesh, Senior Manager of the Investment Cell, pending final disposal of their case.
- (c) An amount of Rs. 8.72 crore as interest due on account of delayed payment of sale proceeds should also be recovered from the brokers Shri R.K. Banthia and Shri Srikant G. Mantri.
- (d) The SEBI should expeditiously complete their investigations in respect of the brokers Shri R.K. Banthia and Shri Srikant G. Mantri and take appropriate action.

#### Indusind Bank

5.198 The IndusInd Bank is one of the clearing Banks of the Calcutta Stock Exchange. According to the procedure existing between the CSE and the Bank, as explained by the Bank

in writing, the Bank receives from Calcutta Stock Exchange each morning a list of pay-in obligations giving details of the name of the broker and amount to be recovered from his account towards his pay-in obligations to CSE. On receipt of the list, the Bank debits the respective broker's account with the amount mentioned in the list, provided that there is sufficient balance in the account of the broker. The corresponding credit is given to CSE-Settlement Account. In respect of accounts where sufficient balance is not available, a shortfall advice is sent to Calcutta Stock Exchange on the same evening with details of broker's code, broker's name, pay-in amount, balance available in the amount and acknowledgement of the stock exchange is obtained. In respect of margin money, Calcutta Stock Exchange neither advises the Bank nor does the Bank have any knowledge of the margin money due from the brokers. Every morning Calcutta Stock Exchange sends the cheques received by them from the brokers against the margin money amount payable by them. On receipt of the cheques from the CSE, the bank debits the cheque amounts to the broker accounts if sufficient balance is available in the accounts of the respective brokers and credits the corresponding amount to the Calcutta Stock Exchange-Margin Account. This process takes place between 10 a.m. and 5 p.m. during the day, when the effects of high value clearings are cleared. The details of all cheques not honoured by 5 p.m. are informed to Calcutta Stock Exchange immediately on telephone and the dishonoured cheques are returned to the Exchange thereafter.

5.199 The problem arose when there was a payment crisis at Calcutta Stock exchange due to the dishonouring of some cheques of the brokers relating to the margin money payable to the Stock Exchange. In fact on 7.3.2001 four cheques amounting to Rs. 15.30 crore had got dishonoured and according to the CSE the Bank had not informed them regarding this on the same day with the result that the Exchange took it as having been credited and hence the interest of the Exchange was jeopardized.

5.200 SEBI in their Interim Report submitted to the JPC had also pointed out that that during March 5-10, 2001, the margin cheques given by the members drawn on IndusInd Bank were returned unpaid after a substantial delay. CSE had taken the matter with the Bank *vide* letter dated 13.3.2001 and had alleged that the Bank had suppressed the fact that the brokers were not having sufficient funds in their account with a motivated intention to protect the interest of the brokers thereby jeopardizing the interest of the Exchange and demanded the Bank to credit Rs. 15.30 crore. In response to this letter IndusInd Bank *vide* its letter dated 14.3.2001 stated that the Bank's executive Shri M. Subhabrata G. Roy had contacted the Vice-President of CSE Shri K.K. Daga and also informed him over telephone regarding the shortage of funds in the accounts of the brokers. Mr Roy was advised by the Vice-President to meet the President along with the list of members who had shortage against margin and when he contacted the President Shri Kamal Parekh in the presence of Shri Raju Bachawat (another Committee member of CSE), he was advised to hold the cheques till further advise. The cheques were then returned on 10.3.2001 at 10.30 A.M. when the staff members came to the Bank. While replying to this letter, the Exchange wrote a letter to the Bank on 15.3.2001, stating that as per the established practice of the Bank, the unpaid cheques had to be returned to the Margin Department of the Exchange and on 7.3.2001, the officers of the Margin Department and the Secretary were working till 7.30 P.M. and the Bank could have contacted any of them. The CSE also denied in the letter that their President had discussed anything regarding the dishonoured cheques with the representative of the Bank and had it been so, he would have directed him to contact the Executive Director or the concerned functionary of the Exchange and that there was no question of the President having given the advice for holding the dishonoured cheques.

5.201 IndusInd Bank again *vide* their letter dated 3.4.2001 maintained that the Bank had contacted the authorized signatories of the Exchange *viz*, Shri K.K. Daga and Shri Kamal Parekh and there was no reason for the Bank to contact any of the departments of CSE after getting

specific instructions from the President of CSE. The Bank also stated that the average balance of the designated account where margin cheques were being deposited was around Rs. 1.92 crore during last year and the highest balance in the account recorded during last one year was Rs. 21.63 crore for just two days in June, 2000 and therefore CSE could not claim that the non-credit of cheques for Rs. 15.30 crore went unnoticed because of long drawn process of reconciling bank accounts.

5.202 While pointing out the above facts in the Report, it has been stated by SEBI that it was clear that the President, the Vice-President and a Committee member of the Exchange did not deny the fact that an officer from the IndusInd Bank had met them and it was likely that only banking matters were discussed, however, what was not clear was as to why the Bank held on the cheques deposited on 5th March till 10th March, whereas the cheques deposited subsequently were returned either the same day or the following day. It was also not clear as to why the Exchange officials had not checked with the Bank for confirmation about the fate of those cheques on 7/3/2001.

5.203 In order to ascertain the correct position, the Committee took evidence of the representatives of CSE as well as the IndusInd Bank. During the course of evidence, the Committee were informed by the Executive Director of CSE that Shri D.K. Singhania, Arihant Exim, Shri Ashok Kumar Poddar and Smt. Prema Poddar, members of the Exchange, had their accounts in the IndusInd bank. As per records of the Exchange, they had received cheques amounting to Rs. 7.09 crore from Smt. D.K. Singhania, Rs. 4.16 crore from Arihant Exim, Rs. 2.23 crore from Shri A.K. Poddar and Rs 1.37 crore from Smt. Prema Poddar. Two of these were deposited by the Exchange on 5th and the other two on 7th March at about 4.30 P.M. The Exchange also had acknowledgements from the Bank. These were all transfer cheques, on which the Bank is in a position to give them immediate credit. He further stated that the normal practice of the Bank was to return dishonoured cheques and in case they were not returned, these were taken as cleared. In these particular cases, they found that these four cheques were returned to the Exchange under the stamp and signatures of the receiving authority on 10 March, at 1 P.M. They immediately wrote to the Bank that it was wrong because based on these credits they had given the pay-out of settlement No 148. Since these cheques were not returned as dishonoured, they took these credits to the members' accounts and made the pay-out.

5.204 On being asked whether the Bank did not send the credit advice, the witness stated that since in the case of margin cheques they were receiving a large number of them the practice was that unless a cheque was dishonoured the Bank did not have the practice of sending the credit advice. He also added that in case a cheque was dishonoured, the Bank intimated the Exchange within 24 hours. The Vice-President of the CSE also denied that he was contacted by any representative of the Bank or he told him to contact the President of the Exchange. His attention was invited to the contents of the letter written by IndusInd Bank on March 14 to CSE wherein it was stated as under:-

"Our Executive contacted the Vice-President of your Executive Committee, Shri K.K. Daga and informed him over the telephone about the fact that there were some major shortages on Members accounts to be debited for Margin. He was advised to immediately come to the President's room with a list of such members and the amounts to be debited. He did as was advised and presented a list of members with the amounts to Shri Kamal Parekh, the President in the presence of Shri Raju Bachawat, another Executive Committee member."

5.205 The President simply stated that it was the version of the Bank. On being asked to state the correct facts and what had actually transpired, the Executive Committee member Shri Bachawat stated that when he was sitting in the Board room, the Manager of the Bank had come and at that point of time he and the President were in the room. The manager talked to the President but what did he actually say he did not know because he was doing some other work at that time. He further added that the Bank Manager Mr. Roy had shown him some slip. The President, however, on being asked whether any Manager of the Bank had met him, denied the same saying that he did not recollect.

5.206 When the M.D. & CEO of the IndusInd bank was asked to state as to what guidelines have been laid down by the RBI for sending intimations regarding return of cheques on account of insufficient balance in drawer's account, the representative stated that as per the guidelines of the RBI, on bank to bank basis, the actual physical cheques are required to be returned within 24 hours, however when the situation is one involving a bank and a client, such as in the case of CSE, there is no specific RBI guidelines. With respect to timing, the requirement is that cheques be returned within a reasonable period of time, which has not been defined. There is no requirement that the client be actually informed by telephone of the return of cheque, but there are some suggestions/recommendations made by Golporia Committee saying that in the event of dishonoured cheque, it should be dispatched from the bank to the client within 24 hours. On being further asked to clarify as to whether as per the convention or guidelines, the bank does not inform the client over phone, the witness replied that it depends from client to client. For the large clients, big companies and institutions, there is a practice to intimate them over telephone. They are the clearing Bank to NSE, BSE and CSE. For NSE, they have an arrangement that they will be intimated on daily basis and they also ask them daily. So it depends upon the arrangement. When asked to state as to whether they are informed on telephone or by sending a person, the witness replied, "Generally it is over telephone. So far we have no arrangement with any client that we will send a person." When asked as to why the information was not passed to the Margin Department and the same was passed on to the broker Director, the witness clarified that on 7th March, the particular broker Director was in fact following throughout the day regarding the fate of various high value cheques. On that day, the Executive Director to whom they normally used to report regarding the dishonoured cheques was not in town, so they sent their representative from the concerned Extension Counter to the broker Director to inform him.

5.207 Besides, the reason why they informed him was that he also happened to be the Authorized Signatory to the operations of the account. He further added that the Bank had got a letter from the Stock Exchange *vide* which they were informed that the President, Vice-President and Treasurer are allowed to operate upon the bank account with them. This letter was given by the Executive Committee. Besides these persons, the Executive Director as well as the Secretary of the Exchange had also been given the powers to sign cheques and operate the bank account. He further clarified that any two persons could operate the account i.e. the President or the Vice-President or the Treasurer or the other Committee members, including the Executive Director and the Secretary. On being asked as to why with regard to the cheques deposited on 5th, the Bank did not contact the Exchange on 7th morning itself, since 6th was a holiday, the witness stated, "Actually, on 7th, there were a lot of other margins which came to us. They were also enquiring regarding Harish Biyani's cheque, about payment shortage and all these things. Throughout the day, they were enquiring. Shri Daga, some brokers and the executive officers also came to the Branch. It is in the same building. They came and enquired about this. There was no fund. We informed everybody." He further stated that at that time they thought it would be better to inform the Executive Committee when everybody would be there since it was a big amount of Rs. 15 crore. So they sent their representative to the President. He went to him where Mr. Bachawat was also present. All the details were given to the President who told him to hold it on till further advice.

5.208 On being asked as to why the Bank held on the cheques till 10th, the witness responded by saying that the Bank had no interest at all in holding these and it was the Exchange which was holding in their own interest. In order to further make his position clear, he stated that on 8th also when Rs. 300 crore pay-in was there, the official of the Exchange knew that no cheques were deposited in the account and they were also fully aware that the cheques were not going to be cleared and there would be huge shortage and every moment they were enquiring whether any fund was coming. He also stated that each day except 7th, they were receiving the demand notice the same day and in the evening they were returning the cheques intimating the CSE in writing. Only on 7th there was an aberration. When asked to state as to what proof he had to substantiate his claim that the representative of the Bank had met the President, particularly when the latter had denied that he ever met any representative of the bank, the witness while saying that they were not just relying on their own submission, drew the attention of the Committee to the letter dated 15th March written by the then Executive Director of the Calcutta Stock Exchange to the Bank, wherein it was stated, "It is true that your representative came to meet Shri Daga to mention this to him. Shri Daga rightly told him to approach the President." This he stated was the submission made by the CSE at that point of time. In view of such an admission the only inference which could be drawn is that their representative had gone to the President in order to apprise him of the position with regard to the dishonour of cheques, and besides Shri Bachawat, the other person who was present there at that point of time also admitted that their representative had indeed come to see the President.

5.209 When asked to state as to what is the practice being followed by the Bank in the case of transfer cheques, the witness replied, "It is the same. If they are not returned by other banks, it would be construed that they are passed. In the case of transfer cheques, once you have informed orally, that would be construed as information." On being asked when in the case of dishonoured cheques the practice followed by the bank was to pass on the information within 24 hours, why in this particular case an exception was made, the witness stated, "What is in point here is that the actual return was done on the 10th morning, but the information that the cheques had been dishonoured was conveyed to the Stock Exchange the very same day, which is on the 7th."

5.210 The letter dated 13.3.2001 written by the Executive Director, CSE to the Manager of the Bank, the reply of the Bank dated 14.3.2001 in response to this letter, another letter of CSE dated 15.3.2001 written again to the Bank and the letter written by the Bank dated 3 April to CSE and also the letter dated 1.11.2000 authorising certain persons to operate the bank account were placed before the Committee. Following is the brief summary of the contents of these letters:

- (i) The Executive Director in his letter dated 13.3.2001 addressed to the Manager of the Bank drew his attention to the fact that that the Exchange had received two intimation letters from the Bank both dated 7.3.2001 for dishonour and return of four cheques due to insufficient balance in the amount of the drawers. These two letters were sent to the Exchange only on 10.3.2001 at around 1.00 P.M. The details were as under:—

Name of Drawer	Cheque No	Cheque Dated	Amount (Rs.)	Deposited Vide Slip No. & Date	Dishonour Intimation Sent by the Bank Date/Time
1	2	3	4	5	6
Dinesh Kumar Singhanian & Co.	884035	5/3/2001	7,09,00,000	1378 dated 5/3/2001 received by the bank on the same day at 4.30 P.M.	Dated 7/3/2001 delivered to the Exchange on 10/3/2001 at 1.00 P.M.

1	2	3	4	5	6
Arihant Exim Script Pvt. Ltd.	303450	5/3/2001	4,61,00,000	1378 dated 5/3/2001 received by the bank on the same day at 4.30 P.M.	Dated 7/3/2001 delivered to the Exchange on 10-3-2001 at 1.00 P.M.
Ashok Kumar Poddar	721527	7/3/2001	2,22,69,000	1381 dated 7/3/2001 received by the bank on the same day at 1.45 P.M.	Dated 7/3/2001 delivered to the Exchange on 10/3/2001 at 1.00 P.M.
Prema Poddar	682854	7/3/2001	1,37,87,000	1381 dated 7/3/2001 received by the bank on the same day at 4.30 P.M.	Dated 7/3/2001 delivered to the Exchange on 10/3/2001 at 1.00 P.M.

It was further alleged that knowing fully well that these cheques had been dishonoured by the Bank, the facts were suppressed from the Exchange with some motivated intention to protect the interest of their customer by jeopardizing the interest of the Exchange. Besides, all these acts were in violation of normal business practices followed by others in the banking fraternity. The Bank was, therefore, advised to credit the total amount of these 4 cheques, amounting to Rs. 15,30,56,000 to the Margin Account of the Exchange in order to enable them to take up the matter with appropriate authorities.

- (ii) The Bank in response to the above letter replied vide their letter dated 14.3.2001 stating that the cheques in the account of Dinesh Kumar Singhania & Co and Arihant Exim Scrip Ltd. were presented well after banking hours on 5th of March and thus were considered for debit on the 7th of March, 6th being a holiday on account of Id. On 7th evening, with no funds being available on the said accounts to be debited, their Executive at the Stock Exchange Extn. Counter, Shri Subhabrata G. Roy was advised immediately to contact the Exchange, considering the high figures involved and the time of the day which was around 6.30 P.M. He contacted the Vice-President Shri K.K.Daga and informed him over the telephone about the fact that there were some major shortages on members' accounts to be debited for margin. He was advised to immediately come to the President's room with a list of such members and the amounts to be debited. He did as advised and presented a list of members with the amounts to Shri Kamal Parekh, the President in the presence of Shri Raju Bachawat, another Executive Committee member. He was asked to hold the cheques till further advice and there was no further advice given till the 10th morning at around 10.30 when staff members of the Exchange came and enquired about the cheques, whereupon they immediately returned the same. There was, however, no occasion of suppression of figures as the balances were always declared immediately over the phone or on their visits to the branch. It was also clarified that the Bank had no liability to pay for members of the Stock Exchange.
- (iii) The Exchange wrote back in their letter dated 15.3.2001 that the Bank had not indicated the correct position. As had been the practice, some cheques for pay-in are received late and they are deposited with the Bank after the working hours and the Exchange had been getting credit for such cheques deposited by them on the next working day. On 5.3.2001 also, they had presented certain cheques issued by their member brokers, particularly Ms D.K.Singhania and Ms Arihant Exim Scrip Pvt.

Limited, late in the evening on that day. Since the cheques were transfer cheques, the Bank could have provided credit to the Exchange on the very day or at least on the morning of the next working day i.e. 7.3.2001. In case the bank found that there was no sufficient fund in the drawers' account, it should have returned the cheques in the morning on 7.3.2001 and in any case by the afternoon of that day. It was also pointed out that even the cheques to be sent for high value clearing are also returned on the very day of the clearing. Besides, as per practice the unpaid cheques are to be returned to the Margin Department of the Exchange. Moreover, the officers of the Margin Department and also the Secretary of the Exchange were working till 7.30 P.M. and the Bank could have contacted any one of them, however, for reasons best known to the Bank it chose to contact Shri Daga who would not be connected with this work. Shri Daga therefore rightly advised the Bank to contact the President. While it was correct that the representative of the Bank had come to the room of the President where Shri Bachawat happened to sit with him, the President did not discuss any issue regarding the dishonoured cheques with the representative of the bank. The observation of the bank stating that the executive staff of the Exchange extracts balances of margin accounts on daily basis and therefore they should have come to know about the non-credit of certain cheques was not tenable as the reconciliation of the bank account statement was a long drawn process and could not be expected to be carried out on day-to-day basis.

- (iv) The Bank in their letter dated 3/4/2001 maintained the same position and stated that their executive had handed over an informal list of cheques intended to be returned and cheques were not returned since they were advised to hold on these by the President. On 10/3/2001 at around 11.45 A.M. the first enquiry from CSE came from Shri Arunava Ghosh of the Margin Department who called on them expressing concern over the non-credit of the cheque proceeds in the accounts of CSE. This obviously indicates that the Margin Department was also aware of the non-credit on the previous working day i.e. on 8.3.2001 or earlier.
- (v) Vide letter dated 1.11.2000. CSE had informed the Manager of IndusInd Bank that at the meeting of the elected members of the Committee held on 29.9.2000, the following Committee Members had been appointed as Hon. Treasures of the Exchange for the year 2000-01. They would operate all the bank accounts and signatures of any two would suffice.

(i) Shri Kamal Parekh	President
(ii) Shri K.K.Daga	Vice-President
(iii) Shri J.M.Choudhary	Committee Member
(iv) Shri Ajit Khandelwal	Committee Member
(v) Shri R.K.Aggarwal	Committee Member
(vi) Shri Bipin Kumar Dewra	Committee Member
(vii) Shri Dinesh Kumar Singhanian	Committee Member
(viii) Shri Girish S. Mehta	Committee Member
(ix) Shri Raj Kumar Bachawat	Committee Member

5.211 The letter further mentions that over and above these, Shri Tapan Dutta, Executive Director and Shri P.K.Ray, Secretary of the Exchange had also been given power to sign cheques and operate the bank accounts.

5.212 The Committee deeply regret that those holding executive positions in the stock exchanges were not only operating the bank accounts of the exchange but they were themselves major brokers operating the share market. The default that occurred in CSE is directly attributed to this nexus and the failure of the IndusInd Bank to return the dishonoured cheques in time.

5.213 The Committee note that delayed intimation regarding the dishonouring of four cheques amounting to Rs 15.30 crore by the IndusInd bank to CSE resulted in making a pay-out by the CSE under the mistaken belief that the cheques had been duly credited and this in turn precipitated the payment crisis which took place in the Calcutta Stock Exchange. Though both the Calcutta Stock Exchange and the IndusInd Bank have tried to put the blame on each other, but the fact that the Bank in this case did not return the dishonoured cheques to the Margin Department of the Exchange, transgressed from the customary banking practice of sending the cheques back to their client within 24 hours and instead sent their representative to the President of the Stock Exchange and then abided by the advice given by him to withhold the cheques, leads to suspicion towards the role played by the Bank as a professional banker. Likewise it can also not be accepted that the officials of the Calcutta Stock Exchange were totally ignorant, more particularly when in one of the letters, their Executive Director himself admitted the fact that the representative of the Bank had contacted their Vice-President who had in turn advised him to see the President and give the list of the members together with the amounts to be debited. This fact has further been corroborated by the member of the Executive Committee. On the basis of the entire evidence and record placed before the Committee, they are inclined to infer that there was collusion between the Bank and the broker.

5.214 The payment crisis in CSE concerning IndusInd Bank leads the Committee to recommend that:—

- (a) Specific guidelines need to be issued by RBI to all clearing banks regarding the procedure to be followed in respect of dishonoured cheques from Stock Exchanges.
- (b) Till Demutualisation is put in place for all the Stock Exchanges, Executive Director or the Secretary or Treasurer, as deemed suitable, may be vested with powers to operate the accounts.
- (c) There is sufficient evidence for the Committee to believe that there was a collusion between IndusInd Bank, CSE and brokers concerned. Any lapse in this regard must be dealt with.

#### Centurion Bank Ltd.

5.215 Centurion Bank was established in 1995 with Keppel, Singapore as copromoter & International Finance Corporation, Washington and Asian Development Bank, Manila as other shareholders. When asked about the shareholding pattern of the Bank, Shri V.S. Srinivasan, Director-in-charge of the Centurion Bank during his deposition before the Committee submitted that 23 per cent is held by TCFC Finance Ltd., 17.5% by Keppel Group, Singapore, 10.5% by Asian Development Bank, Manila & 7.5 per cent by International Finance Corporation, Washington.

5.216 The RBI has submitted that during a review made in June, 2000, it was observed that the bank had granted substantial advances to corporates for subscribing to IPOs in violation of RBI directives. During January 2000 advances for subscribing to IPOs stood at Rs.517.87 crore. Accordingly, a show cause notice was issued to the Bank. In response to the show cause notice the Bank had submitted that financing of IPOs cannot be construed as loans against shares since at the financing stage there were no shares at all. The Bank was of the view that the existing instructions did not specifically prohibit banks from financing of IPOs. The explanation

submitted by the bank was examined and the RBI accepted the contention of the bank that since the guidelines were not very specific on this issue, there was an area of ambiguity. In order to remove any doubts on this score, RBI therefore, issued guidelines in November 2000, which specifically covered banks financing of IPOs also.

5.217 During the evidence of the representatives of the Centurion Bank before the Committee on 29.10.2002, Shri Dev Ahuja, the then non-executive Chairman of the Bank giving a brief account of the bank submitted that the bank started capital market activities in January-February, 1999 and also did IPO financing towards the later part of the year i.e. in September, 1999 which come to an end by March, 2000.

5.218 Regarding the accounts of Shri Ketan Parekh with the Centurion Bank, the Committee were told that the Bank had three borrowing accounts of the Ketan Parekh Group and the total limits sanctioned were of Rs.60 crore but were subsequently reduced. The Committee were also informed that the current outstanding amount was Rs.42 crore and the limits have been frozen at that outstanding position as per the decision of the Board. It was submitted that against the outstanding amount, the bank had securities of shares whose current market value was Rs. 7 crore.

5.219 On being asked to comment on the observations made in the report of the SEBI that the Bank had indulged in a negotiated deal with a Ketan Parekh related company called Classic Credit Limited on 26.11.1999 regarding buying and selling of 2 lakh shares of Afftek Infosys Limited by the bank through a common set of brokers amounting to circular trading and negotiated dealing to create artificial volumes, the representative of the bank submitted that:

“It is correct that on the date specified the Centurion Bank did buy and sell shares of Afftek Infosys. Actually, the shares we acquired were not from Classic Stockbroking. It was from another company affiliated to the Ketan Parekh Group. We bought the shares in the morning around ten o'clock and disposed of the shares after the share price movements hit the ceiling limit of eight per cent sometime in the afternoon to two different brokerage houses that are not part of the Ketan Parekh entity. This proposal was put up by the dealing officer of our capital markets division. Based on analysis of technicals, he had predicted the price movement. On that basis, we had invested and later got out. This is the factual position.”

5.220 Shri Dev Ahuja Speaking on his relationship with the Centurion Bank informed the Committee that he was appointed as the non-executive Chairman of the Bank to Chair the Board meetings after the last Chairman stepped down. Now, the Bank had appointed Shri Janakiraman as CMD. To a query of the Committee, Shri Dev Ahuja also informed the Committee that TCFC Securities Ltd., has shares aggregating Rs.25 lakh of the Bank's equity and he has no personal holding in TCFC Securities. He also agreed to the query that 45 per cent of TCFC Securities Ltd. is owned by TCFC Finance and Consultancy Ltd. and 20% by Twentieth Century Holding Private Limited which is owned by him. He denied that Centurion Bank was financier of TCFC Securities Ltd., and it has no relationship with the Bank.

5.221 On being asked whether the Bank has ever violated any stock market norm laid down by RBI, Shri V.S. Srinivasan, Director-in-charge of the Bank submitted that about four or five years back, the bank had violated one particular norm on the issue of stock invest to a party who did not directly have an account.

5.222 The capital market activities of the Centurion Bank have also been found mentioned in various investigation reports of SEBI regarding manipulation of share prices of various corporate houses as mentioned below:

- (i) In the case of Affeck Infosys Ltd., the SEBI while analyzing the movement of share prices between 15.11.1999 to 14.12.1999, has pointed out that a transaction of particular note which merits special mention involved 3 brokers—Triumph Securities Ltd., Milan Mahendra Securities Ltd. and Latin Manharlal Securities Ltd. The transaction took place on 26.11.1999. On this day, out of the total volume of 4,79,067 shares, volume of 4,00,000 shares was created due to the reversal of trades between Centurion Bank Ltd. and Classic Credit Ltd. The deal structure was as follows:

- Centurion Bank bought 200000 shares @ Rs.837 at 10.10 hrs. from Classic Credit Ltd.
- Centurion Bank sold 100,000 shares @ 890 and 98,565 shares @ Rs.880 at 14.08 hrs. and 14.29 hrs.

On this day, Centurion Bank had bought and sold 2,00,000 shares and the counter party for almost the entire transaction was Classic Credit. The SEBI has observed that selling of 2,00,000 shares at lower price in the morning at the rate of Rs.837/- per share and buying the same quantity at higher price i.e. 880/890 per share in the afternoon, no genuine investor would like to lose Rs.1 crore. The exact relationship between Classic Credit Ltd. and Centurion Bank is being probed separately. This transaction created artificial market and volumes for the scrip. It also resulted in price distortion. While, the brokers who carried out the transaction stated that they did so as per the instructions of their clients, it cannot be a mere coincidence that the individual transactions comprising this entire deal occurred in such a manner. It is improbable to have the same broker, same number of shares, same/related clients, matching and proximity for the entire deal. Especially so when the quantity for each transaction of buy and sell is of such a large magnitude. It is more plausible that the entire deal was a structured deal and was given the colour of buy and sell transaction. Thus there was misuse of the trading system.

- (iii) In the case of Ranbaxy Laboratories Ltd., the SEBI has investigated price movement between January 1999 to October 1999 and has observed that the Centurion Bank had dealt (purchase as well as sales) in the scrip only through the brokers connected/ associated with the entities of KP Group. The bank had purchased 36,57,500 shares of RLL and sold an equal quantity during this period; The transactions of the bank are mostly of arbitrage/trading in nature i.e. purchases and sales were made on the same day/settlement either in the same Exchange or the other Exchanges; From the details of the transactions it was seen that on 26.10.1999 the bank purchased 1,25,000 shares through NH Securities at NSE @ Rs.1031/- and sold the same quantity through Milan Mahendra Securities Ltd. of NSE on the same day @ Rs. 984.40. The transaction is an arbitrage transaction. Similarly, it has bought 1,65,000 shares through Triumph International at NSE on 06.04.1999 and sold the same quantity at BSE on the same day through Triumph Securities. Further transactions of similar nature were observed from the details. These transactions appear to be of trading/arbitrage transactions. As per the RBI Guidelines the banks are required to deal only on delivery basis i.e. take delivery for the purchases and give delivery for their sales. The transactions mentioned above particularly that of the 26.10.99 etc. were of arbitrage nature and are in violation of RBI Guidelines. On perusal of the trade log of the aforesaid transactions it was found that most of the transactions were in the nature of cross deals entered by the broker on behalf of the bank on one hand and the entities connected/ associated with KP Group of entities on the other side.

- (iv) In the case of Global Telesystem Ltd., the SEBI in their investigation report has observed that at NSE Classic Share and Stock Broking (CSSB) has executed cross deals for 1,71,000 shares of GTL Limited on behalf of Classic Credit as the buying client and Centurion Bank as the selling client. This traded quantity constituted 13% of the total quantity traded in the scrip on that day. SEBI has further observed that at NSE Centurion Bank had purchased 2557767 shares and sold 1777767 shares in the rise period resulting in a net purchase of 780000 shares. In the fall period at NSE it was observed that Centurion Bank had bought 1780000 shares and sold 1765000 shares resulting in a net purchase of 25000 shares. In the rise period at BSE it was observed that Centurion Bank had sold 780000 shares.
- (v) The SEBI in their investigation report on Lupin Laboratories Ltd. has observed that a number of transactions involving large volumes of shares both at NSE and BSE involved transactions between Ketan Parekh entities and the Centurion Bank as buyer/seller and seller/buyer during September 1999 to January, 2000.
- (vi) From SEBI investigation report of Silverline Technologies, which provides information on month-wise shareholding pattern in the company, the following is seen:

Month	Shareholding in Silverline Technologies	
	By Centurion Bank	By 20th Century Finance
November 1999	Nil	Nil
December 1999	2,65,000	Nil
March 1999	24,000	1,58,200
June 2000	24,000	1,61,957

In the above case, question of conflict of interest is to be examined because the Bank has taken a position in the scrip and subsequently the bank reduces its position, while the group company increases its position.

- (vii) Pentamedia graphics has made a third preferential offer of 10,00,000 shares and allotted the entire quantity to one entity Malu Financial Securities Ltd. on 1.1.2001 with a lock-in of one-year upto 31.1.2002. SEBI recived a complaint on non-compliance of the lock-in guidelines. As per SEBI investigations, it appears that MFSL wanted shares to be credited in the demat a/c of Nikko Securities with Centurion Bank. Though there is a lock-in of one year, Centurion Bank had claimed that the shares are pledged to the Bank. SEBI is investigating the matter.
- (viii) From the scrutiny of the SEBI's investigation report on Khemani Group, it is seen that the Centurion Bank had been involved in 2000-2001 in the scrips of Adani Export, HFCL and TIPs India. Such off the floor transactions (i.e. other than exchange screen based) are prohibited under SEBI guidelines.

**5.223 It appear to the Committee that Centurion Bank has been transgressing prudential norms of banking and have been taking large exposure to capital market, both by way of loans and direct equity investments. The Committee have noted following observations of SEBI:**

- (a) Involvement of Centurion Bank, where the broker and the buyer are Ketan Parekh entities in every transaction.
- (b) The Bank seems to have participated in manipulative trades.

- (c) According to SEBI report, transactions suffer from the synchronized deals, cross deals, structured deals and circular deals. There are many transactions of buy & sell on the same day. RBI has clear regulations prohibiting banks from making a sale or purchase without giving or taking delivery. Centurion Bank appears to have violated this by buying and selling the shares on the same day.

5.224 The Committee suggest that RBI should ensure that prudential norms are clearly laid down and strictly enforced.

## **CHAPTER VI**

### **STOCK EXCHANGES**

6.1 The Stock Exchanges are institutions which provide a mechanism for trading of securities. In India, the stock exchanges have been set up in diverse organizational structures over a period of time spanning more than 100 years. Some of these exchanges are association of persons and others are set up as companies limited by shares or guarantees. One of the important functions of the exchanges is to monitor trading activity to ensure fairness and integrity of trading. As a part of such monitoring activity exchanges also analyse trading data, positions of the members etc. and take up investigations. The bye-laws of the stock exchanges provide for, among other things, powers to take disciplinary action against members.

6.2 Stock exchanges are governed by their respective Governing Boards. Under SEBI directive, the constitution of the Governing Boards of the stock exchanges were changed to restrict the representation of member brokers to 50%. The balance 50% of members of the governing board comprises persons who are not brokers. Generally they comprise members of the judiciary, academicians, professionals such as chartered accountants, representatives of Department of Company Affairs, representatives of State Governments and SEBI officials. The executive director of the stock exchange who is not a broker is also on the board of the exchange. The exchanges were also directed by SEBI to reconstitute three important committees namely Arbitration, Disciplinary and Default Committees. Members of these committee to be non-brokers in majority and not more than 40% of the members of these committees can be brokers.

6.3 The scam under investigation by JPC mainly related to the stock market. Since there was a payment crisis in the Calcutta Stock Exchange in March 2001, the Committee examined the role of CSE in detail. The Committee also looked into the surveillance aspect of the Stock Exchange, Mumbai and the Automated Lending and Borrowing Mechanism (ALBM) of the National Stock Exchange.

#### **1. CALCUTTA STOCK EXCHANGE**

6.4 The Calcutta Stock Exchange Association Ltd. (CSE), was registered on 7.6.1923 under the Indian Companies Act, VII of 1913. The Exchange was governed by its Memorandum and Articles of Association. Trading rights are available only to those persons who are the shareholders of the CSE. The Managing Committee (Governing Board) of the CSE comprised nineteen members as in March, 2001, including nine elected by broker members and one Executive Director, an employee of the Exchange. The composition of the Governing Board as on 31.3.2001 is given in Appendix VII. One of the members of the Committee, Shri Dinesh Kumar Singhania emerged to be the highest defaulter in the Settlements no.2001148, no.2001149 and no. 2001150 covering the period from 1.3.2001 to 15.3.2001. Following the settlement crisis, he resigned. Eight other elected members also resigned from the Committee. Subsequently, the residual Committee of CSE constituted a five-member Sub-Committee with Shri D.Basu as its Chairman.

6.5 In terms of business volume, Calcutta Stock Exchange is the third largest exchange in the country. During the last three years, there has been an increase in the volume of business. The

annual turn over of CSE was Rs. 1,71,780 crore during 1998-99 Rs. 3,57,165 crore during 1999-2000 and Rs. 3,55,035 crore during 2000-2001. The share of CSE's turnover in total turnover of exchanges constituted 17% in 1998-99 as well as in 1999-2000 and 12% in 2000-2001. Although in terms of volume and trading turnover this exchange figures third in the country, during the period of the present scam it suffered from maximum irregularities and misconduct.

#### A. Payment Problem

6.6 After the post-budget fall in market prices, a payment problem arose in the CSE in settlement no. 2001148 which ended on 1.3.2001 and it continued up to settlement no. 2001150, which ended on 15.3.2001. The total pay-in default in the CSE in the three settlements no. 148, 149, and 150 was Rs.120 crore which was met by the CSE partly by utilizing the Settlement Guarantee Fund (SGF) of the exchange and from other resources of the Exchange.

6.7 Ten brokers who had a short-fall of about Rs. 107 crore in pay-in obligation in these settlements were declared defaulters by the Committee of CSE. Their names and settlement wise net-outstanding position are given in Table below:—

#### Net outstanding position of the defaulters in the CSE

(Rs. in Crore)

Sl.No.	Name of the Defaulter	Net Outstanding			Total Net Outstanding
		Settlement No. 148; Payout on 10.3.2001	Settlement No.149; Payout on 16.3.2001	Settlement No. 150; Payout on 23.3.2001	
1.	Harish Chandra Biyani	20.08	2.49	3.14	25.71
2.	Biyani Securities (P) Ltd.	0.79	3.06	3.16	7.01
3.	Ashok Kumar Poddar	0.85	0.87	14.46	16.18
4.	Prema Poddar	1.16	1.09	5.79	8.04
5.	Raj Kumar Poddar	Nil	0.05	6.02	6.07
6.	Ratan Lal Poddar	Nil	1.17	5.35	6.52
7.	Dinesh Kumar Singhania & Co.	0.12	0.90	4.83	5.85
8.	Doe Jones Investments & Consultants Pvt. Ltd.	Nil	3.94	10.99	14.93
9.	Arihant Exim Script Pvt. Ltd.	9.61	-1.18	6.47	14.90
10.	Tripoli Consultancy Services	Nil	0.69	1.05	1.74
	Total	32.61	13.08	61.26	106.95

6.8 In addition to the above, there were certain smaller members who had difficulty in making pay-in for the Settlement nos. 2001148 to 2001150 aggregating to Rs. 5 crore after adjustment of Bank Guarantees, Fixed Deposits, etc.

6.9 The net position of the three settlements and the way the CSE had completed the pay out is as follows:

			(Rs. In Crore)
Settlement No.	Defaulters	Others	Total
148	32.60	—	32.60
149	13.08	8.75	21.83
150	61.25	4.71	65.96
	106.93	13.96	120.39

6.10 According to CSE Executive Director report in settlement no. 2001148 on 8.3.01, for the trading period ending 1.3.01, it was found at 8 p.m. that two entities, Arihant and Harish Biyani, still had pay-in liabilities. Although the next day, 9.3.01, was a holiday, members of the CSE Committee met to resolve the outstanding payment problem and came to the conclusion that the only way out was to find buyers for two large blocs of shares in question, 28.42 lakhs of Himachal Futuristic Communications Ltd. and 13.30 lakhs of DSQ Software India Ltd. UTI agreed that evening to buy the DSQ shares for a net consideration of Rs. 25.13 crore, while members of the exchange who had a funds pay-out position were persuaded to pick up the HFCL shares at a discount of nearly Rs. 100 per share compared to the previous closing. This raised a further Rs. 48 crore. Defaulter Biyani's bank pledged a further Rs. 15 crore against demat conversion of Biyani's physical holdings of Zee Telefilms Ltd. shares. Against this background, pay-out for the remaining two entities was declared on the evening of 9.3.01.

6.11 However, on 10.3.01, IndusInd Bank returned cheques worth Rs. 16 crore accounted for as margin money from the defaulters. There followed other withdrawals from commitments made earlier. In the subsequent scrutiny of pay-in/pay-out, a number of non-genuine trades were discovered and annulled. Thus settlement no. 2001148 eventually ended with a significant shortfall.

6.12 In the following settlement a week later, more shortfalls for the trading period ending 8.3.01 were unearthed. This was compounded by yet more shortfalls at the next pay-out on 23.3.01 in settlement no. 2001150. At that stage, CSE was left with no alternative but to exhaust most of its Settlement Guarantee Fund and substantially dip into its General Reserve to facilitate the pay-out.

6.13 The CSE Committee met again at 7:30 p.m. on 12.3.2001, on the eve of the Calling Attention Motion in the Rajya Sabha the following day. **The Committee have perused the Minutes of that meeting and note that the senior SEBI official nominee on the CSE Committee did not attend the meeting called at short notice although the crisis on CSE had become a matter of deep public concern.** SEBI was represented by its another nominee—a representative of State Government. The first two paragraphs of the Minutes indicate that the priority concern was with regard to "the current discouraging news being carried in the media regarding the functioning of the Exchange". This was expressed in the Committee's desire "that the Exchange should initiate steps for undertaking proper media management and ensure that the Press is briefed with the required factual information at the end of the day to obviate the possibility of disparaging press reports." To this end, a crisis management team was set up.

6.14 The Executive Director of CSE then presented a report on the Clearing & Settlement process for the Settlement no. 2001148. This is the same official whose report has been cited above. The Minutes note the process by which “pay-out was completed”, The Minutes then go on to state:

“The Exchange authorities are currently assessing the situation for the next pay-in and pay-out scheduled for 15.3.2001 and 16.3.2001 in respect of Settlement no. 2001149. The net payment obligation in this Settlement is approx. Rs. 270 crores and the outstanding position for the settlement which commenced on Friday 9.3.2001 was Rs. 716.35 crores against which the Exchange has a margin and ABMC cover of Rs. 603.37 crores. The Exchange is reviewing the pay-in obligations of the brokers to ensure smooth pay-in and pay-out and would be asking for early pay-in of securities/funds whenever warranted. The Exchange after taking such measures expects to have smooth pay-in and pay-out in the settlement no. 2001149.”

6.15 On 13.3.2001, the then Finance Minister told the Rajya Sabha:

“I have been assured by SEBI that there is no systemic risk to the market and there is no danger of a payment crisis.”

6.16 Later, replying to the debate, the Finance Minister said:

“Sir, as far as the payment problem is concerned, there has been no payment problem so far.... There was just a delay because of the fact that some banks were closed etc., there was a delay of one day in....I am assured by SEBI that the funds available, the trade guarantee funds which are available with the stock exchanges, are sufficient to be able to take care of any problem.”

6.17 The Committee note that while the Exchange would be “asking for early pay-in of securities/funds”, it was not known whether the brokers concerned would be able to do so since the Exchange, as on 12.3.2001, were still engaged in “assessing the situation”. It was only “after taking such measures”, which were still to be taken, that the Exchange said it “expects to have smooth pay-in and pay-out in settlement no. 2001149.”

6.18 Although the media and public opinion in general were exercised about CSE, SEBI, as the secondary but statutory regulator, failed to query any part of the proceedings of the CSE Committee on 12.3.2001. It failed also to anticipate the continuation of the payments problem in CSE beyond its Settlement no. 148 as well as the ultimate magnitude of the payment problem, as reflected in the interventions of the Finance Minister in the Rajya Sabha on 13.3.2001. The Executive Director’s report on how pay-in/pay-out was effected in Settlement no. 2001148 and the CSE Committee’s expectation of a smooth pay-in/pay-out in the next settlement was accepted at face value and passed on as such to the Finance Minister.

6.19 The Committee are of the considered view that, at bottom, the payments crisis on CSE arose because the SEBI in consultation with the Ministry of Finance had permitted the resumption of *badla* without arranging for curbing or regulating rampant off-market “internal *badla*”. SEBI should have ensured the rectification of the errors revealed in SEBI’s own inspection reports. The UTI Chairman was used or persuaded to exercise his discretion of bail out the pay-in by making massive purchases of dud shares owned by the defaulting brokers, inflicting serious losses on small investors who looked upon UTI as a government-regulated mutual fund. Everyone concerned—the Ministry, the Regulator, CSE—ought to have seriously addressed themselves to the systemic deficiencies in CSE when its turnover was exponentially increasing. They did not because, it would appear, no one was interested in intervening when the going was good.

6.20 Shortage of Rs.120 crore was met out of the following resources:

Settlement Guarantee Fund	—	Rs.48 crore
Reserves of the exchange	—	Rs.20 crore
Counter parties recoveries	—	Rs.28 crore
Margin Money	—	Rs.24 crore
Total	—	Rs.120 crore

6.21 A number of large brokers have more than one card in CSE which are either in the name of their family members or companies where they are major share holders. The list of defaulting members as grouped by SEBI is as follows:-

DK Singhania Group	AK Poddar Group	H.Biyani Group
1. D.K. Singhania	1. A.K. Poddar	1. Harish Biyani
2. Tripoli Consultancy	2. Prema Poddar	2. Harish Biyani & Co.
3. Arihant Eximp Scrip P. Ltd.	3. Ratan Lal Poddar	
4. Doe Jones	4. R.K. Poddar	

6.22 The Exchange declared the aforesaid members as defaulters on 26.03.2001 and suspended them under the relevant provisions of the Bye-laws and Regulations and Articles of Association of the Exchange. These broking entities are also among the large top brokers of the exchange. Moreover, Shri D.K. Singhania who has the largest default was a member of the Committee of Directors of CSE as an elected member.

6.23 The recovery proceedings against the aforesaid defaulters, including initiation of civil and criminal proceedings against the defaulting members, for recovery of dues have reportedly been filed in appropriate courts in consultation with M/s. Sandersons & Morgan, Solicitors approved by the Exchange for the purpose. The Exchange had filed criminal proceedings against five defaulting members under Section 138 of the Negotiable Instruments Act, 1881 as amended by the Banking, Public, Financial Institutions and Negotiable Instruments (Amendment) Act, 1988. Further, civil suits have also been initiated against the nine defaulting members.

6.24 Some of the recoveries made were as under:-

- (i) Sale of securities of the defaulting members both of security deposit and securities pay-out a/c. aggregating to Rs.6.5 crore.
- (ii) A sum of Rs.2 crore received by the sale of Global Mascom Shares were partially appropriated towards dues of M/s. Prema Poddar (Rs.68 lakhs)
- (iii) An amount of Rs.70 lakh received from M/s. Prema Poddar towards dues to the Exchange.

According to CSE, after recovery of the aforementioned amounts, the net outstanding amount against the defaulter groups after adjustment of bank guarantees, fixed deposits and shares deposited by way of securities aggregated to Rs.91.37 crore.

6.25 SEBI further stated that as the pay-out for the three settlements was completed as per schedule, all investors got their due amounts or securities on time and there was no possibility of any adverse impact in real terms on the other stock exchanges or the overall stock market.

6.26 Asked about the impact of CSE payment crisis on the stock market, SEBI informed in a post evidence reply that the actual net impact on the reserves of CSE was only Rs. 10.98 crore as per the Balance Sheet of CSE for the year 2000-01. The total business done by CSE in the three settlements was Rs. 14,629 crore and the total turn over during the relevant three weeks period in NSE, BSE & CSE was around Rs. 1,19,000 crore. The payment shortfall in CSE was Rs. 96.59 crore which was only 0.66% of the total business done on the CSE and 0.08% of the total business done in the major 3 exchanges during the relevant three weeks. SEBI stated that the market sentiment all over the country was, however, affected when the shortfall at CSE was reported.

6.27 It transpired during the Committee's examination that Shri Ketan Parekh and his associated entities had linkage with CSE brokers. Shri Ketan Parekh during his evidence before the Committee stated that his entities were doing lot of arbitrage between CSE, BSE and NSE. They used to buy from CSE and sell later on in BSE or keep it as part of the portfolio. This was done on the cards of members of CSE. He informed the Committee that his entities dealt with 43 brokers of CSE of whom Shri D.K. Singhania, Shri Sanjay Khemani, Shri Ashok Kumar Poddar and Shri Krishan Kumar Daga were the main brokers.

6.28 The reasons for the payment problem in CSE as reported by SEBI were as follows:—

- (i) Building up of large outstanding position by a few brokers in a few scrips mainly in HFCL and DSQ.
- (ii) Volatility in prices during the relevant period. Downward movement in the prices of HFCL and DSQ.
- (iii) Violation of SEBI directives regarding gross exposure limits and margins.
- (iv) Failure to take timely action for non-payment of margin on T + 1 basis.
- (v) Understatement of margin due to software error in computer system for computing gross exposure margin.
- (vi) Failure of surveillance department of CSE to detect concentration of position built by a few brokers in HFCL and DSQ and to take preventive action.

6.29 On the basis of the findings of its inspection of CSE in May 2001, SEBI has made the following recommendations:—

- (a) It is important to take immediate corrective action in the area of surveillance and risk management and responsibility be fixed on the officials for failure.
- (b) Existing surveillance and risk management function should be thoroughly reviewed, overhauled and strengthened by putting a senior officer in the department. The Executive Director should closely supervise these functions as it is finally the Executive Director of the Exchange who is responsible for the same.

- (c) The surveillance department should activate all the alerts and have proper benchmarks, closely monitor the positions, particularly the large brokers and their trading, circular trading and shifting of positions within the same group of brokers. After analyzing the alerts, they should take proactive action to prevent unsustainable position built-up leading to defaults in the market.
- (d) Besides, the existing computer systems of the exchange should be revamped after the systems have been audited. An audit of the exchange systems should be conducted by an independent group of computer system auditors to ensure that the system is free from bugs and it is secured.
- (e) The error in computation of margin should be corrected immediately and appropriate amount of margin should be collected from the members strictly in accordance with T + 1 system.
- (f) Reporting of inter-market positions of the broker should be introduced so that the exchange will have reasonable understanding of the outstanding position of the broker in other exchanges and accordingly take a view on the ability of the broker to honour his commitment to the exchange vis-a-vis his position.
- (g) Immediate efforts should be made to augment the size of the Settlement Guarantee Fund . Pending augmentation of SGF, the exchange should reduce the scrip-wise as well as broker wise exposure norms.

6.30 SEBI stated in a written reply that CSE could have prevented the “payment crisis” by strictly following the SEBI directives on margins and exposure limits.

6.31 On the basis of a written complaint of CSE, a case was registered by Kolkata Police against the defaulted brokers. According to Kolkata Police all the defaulted brokers(firms) have acted together to defraud CSE’s Settlement Guarantee Fund by way of circular trading between themselves and Badla transaction etc. having nexus with Ketan Parekh a broker of Mumbai Stock Exchange.

6.32 According to Kolkata Police the accused persons have also siphoned off their funds, assets etc. to various accounts of their kith and kin, business associates in ‘Benami’ etc. They also conspired with bank officials in withholding the fate of margin cheques issued to the Stock Exchange by them thereby causing wrongful pecuniary loss to the exchange to the extent of margin collection of several crores and denying the exchange the opportunity to close down the terminal and restricting the loss suffered resulting their wrongful gain for several crores by using the terminal illegally.

6.33 According to the information furnished by Kolkata Police as on 12.11.2002, 13 accused persons have so far been arrested. They are (1) Harish Chandra Biyani (2) Ramesh Chandra Biyani (3) Raj Kumar Jain @ Patni, @ Jain (4) Gopal Singhania (5) Basudeb Singhania (6) Bijoy Kumar Singhania (7) Kishan Kumar Sharma (8) Dinesh Jain (9) Badinehal Virupaksha Goud (10) Santi Nath Paul (11) Krishna Kumar Daga (12) Binod Kumar Dalmia (13) Dilip Khanna. Some of the FIR named persons including Ashok Kumar Poddar, D.K. Singhania, Dinesh Dalmia and Ketan Parekh are reportedly still absconding. Kolkata Police have stated that they are making vigorous attempts to apprehend the aforesaid persons and their close associates. Search, seizure and examination of voluminous documents and reports including bank statements are stated to be in progress.

## B. Deficiencies in Surveillance

6.34 The on-line and off-line surveillance in CSE is performed through the stock watch surveillance system known as Advanced Warning and Control System (AWACS). The software system generates Alerts on the basis of database, on-line data feed and benchmarking. Some of the alerts are as under:

1. Alert when the traded price is greater than a certain percentage of the last traded price.
2. Alert if the intra day high low variation in the security as compared to the previous close of the security is more than a certain percentage.
3. Alert when negotiated price comparison with respect to normal trade price is greater than a certain percentage.
4. Alert when volume of a large order compared with the floating stock of the company.
5. Alert for securities trading close to the price band, etc.

6.35 The stock watch system is designed to generate alerts based on system generated and manually set up benchmarks. These benchmarks are set up based on several parameters such as price change, large trade quantity in a scrip, large trade orders, order size compared to floating stock. The system also has features for observing concentration in a few scrips, exposures of members in scrips etc.

6.36 Pointing out that the Exchange surveillance should have been able to detect concentration of trades by a few brokers in a few scrips, SEBI has indicated the following:—

- (i) The alerts generated by surveillance system particularly in case of those volatile and active scrips were reportedly either ignored or not pursued seriously by CSE. There was a high concentration of activity (large number of big orders and large trade size) in two scrips namely, HFCL and DSQ by a few broker members during the Sett. no. 148 and 149 in which period the “payment crisis” occurred.
- (ii) Even though the facility of finding out members’ matching trade and shifting of positions in circular fashion is available with the Exchange, no proactive role was taken by them at any point of time to find out the nature and likely impact of such transactions. There were large number of matched trades in several scrips, mostly in those volatile scrips.
- (iii) The Exchange reviewed the benchmarks for the generation of alerts in May/June, 2000 and fixed the single trade size bench mark at 90,000 across all categories of shares i.e. irrespective of specified, B-group, highly traded or illiquid shares, from the earlier limit of 20,000 for share price exceeding Rs.150. This could possibly be one of the reasons for the inability of the Exchange to detect large and concentrated trades by the brokers in those highly traded scrips. The above change in the bench mark was reportedly done by the Executive Director (Shri Tapas Datta) in consultation with the Surveillance staff.

6.37 Another fall out of pegging the order size benchmark at 90,000 uniformly across all categories of shares irrespective of whether they are illiquid and thinly traded, was the failure in detecting the trades of one of the defaulting members, Shri Harish Biyani with own firm Harish Biyani & Co. in 9.6 lakhs shares of DSQ Industries Ltd. (not DSQ Software) worth Rs.32.48 crore (in two sets of transaction) in the Rolling segment where trading was very thin.

6.38 Asked how SEBI could not notice this unrealistic benchmark during its inspection of CSE, a representative of SEBI stated that the inspection of CSE conducted in September, 2000 was a routine general inspection and that it did not look into the surveillance areas. A surveillance inspection of CSE had been carried out in December, 1999 for the financial year 1999-2000. For the financial year 2000-01, the inspection was to be conducted in March 2001. However, because of the events which unfolded in the beginning of March 2001, it had to be deferred to April-May, 2001.

6.39 Shri Tapas Datta, the then Executive Director of CSE candidly admitted in this regard in a written reply:

“As Executive Director, I was aware that most brokers preferred to have concentrated position in volatile ICE stocks within the overall carry forward limits permitted under the SEBI guidelines. However, I did not visualize that such concentration could snowball into payment crisis on the Exchange”

### **C. Deficiencies in Risk Management System**

#### **(i) Exclusion of crystallized position**

6.40 According to SEBI circular of 2.7.1999 the total net outstanding position of a broker shall be taken into account for the purpose of gross exposure computation. The long position crystallized at the end of the previous settlement should also be included in the outstanding position of the brokers for the purpose of exposure limit and margins. This was not being done by CSE. The gross exposure computed by CSE used to be lower on account of exclusion of crystallized purchase position. According to CSE, all crystallized deliveries pertaining to the previous settlement were subject to Mark-to-Market margin.

6.41 Due to non-inclusion of crystallized delivery on 1.3.2001 in case of Shri Dinesh Kumar Singhania for a delivery of Rs.77 crore and non-inclusion of delivery of Rs.84.05 crore in respect of Arihant Exim Scrips Pvt. Ltd. totaling to Rs.161.05 crore, the gross exposure adjustable against capital would have been Rs.8 crore approximately. Enquired whether the exchange sought any clarification from SEBI in this regard, CSE stated in a written reply that CSE had not approached SEBI because this came to their notice only when SEBI conducted inspection after the payment crisis.

6.42 During oral evidence on 10.10.2001, the Chairman, Management Sub-Committee of CSE (Shri D.Basu) was forthright in his admission:

“It is generally a matter of common sense because when we are measuring exposure we have to take carry forward exposure also into account. My personal opinion is that we should have referred it to the SEBI at that time and not interpreted it in a particular way”

6.43 Replying to another query in this regard, the witness said:

“What we did not have was an independent internal audit to see that this was being done.... I think our internal audit should have covered, on a random basis, a check to see that the randomly picked up margin calculation was in order.”

6.44 SEBI conducted annual inspection of CSE in October 1999 and September, 2000. The witness also said in this context: “In the year 2000, inspections were carried out at the Calcutta Stock Exchange and the fact that the margins were not being collected as per the circular do

not get reflected in the inspection". The Committee observed that this was a major failure of the regulatory authority. Asked whose fault was it that, the SEBI inspection did not reveal the non-compliance, the witness said: "I feel that what we really need to do is to get system's audit". SEBI in its interim report has also recommended that CSE should appoint an independent systems auditor to carry out thorough review of the systems of the exchange and also enquire into the reasons for the deficiencies in the system.

**(ii) Violation of exposure limits**

6.45 SEBI had fixed in January, 1998 that the upper limit for the gross exposure of the brokers should be 20 times their Base Minimum Capital and Additional Base Minimum Capital. The additional capital lying with the Exchange can be utilized for the purpose of meeting margin requirements only after meeting the requirements of gross exposure. When additional capital of the brokers is utilized against their margin liabilities, the gross exposure on the following trading day should be computed based on such adjusted (reduced) additional capital. However, CSE was not deducting the additional capital, which had been so utilized against margin liability for computation of gross exposure limit of the brokers. This diluted the risk management mechanism prescribed by SEBI. There was no control in the CSE's trading system to prevent the brokers from continuing with their existing outstanding positions and also building up further positions when their margin liability exceeded their total capital. As a result, violation of exposure limit by D.K. Singhania was Rs. 93.94 crore on 1.3.2001 and Rs. 109.40 crore on 2.03.2001; Arihant Exim Rs. 96.41 crore on 1.03.2001 and Rs. 104.97 on 2.03.2001; Doe Jones Rs. 48.37 crore on 1.03.2001; H.C. Biyani Rs. 64.60 crore on 28.02.2001 and A.K. Poddar Rs. 75.87 crore on 27.02.2001.

6.46 When enquired about the reasons for not preventing violation of exposure limits by brokers, the former executive Director of CSE said on 10.10.2001 that Mark-to-Market margin was supposed to be paid on T+1 basis and the logic was that if the Mark-to-Market margin was payable one day later why it should be reduced on the same day. To a query whether the system has since been rectified the witness said "we have taken some action on that".

6.47 SEBI had suggested in its inspection reports of September 1998 and October 1999 that the Exchange should not adjust the amount deposited by the Members towards additional capital against the margin liability.

**(iii) Software error**

6.48 Estimation of margins was made by the margin module of C Star software developed and maintained by CMC Ltd. After the payment crisis, the Exchange officials have reportedly identified that incorrect gross exposure margin was being charged in certain cases where members had large exposure. It was found that the programme module used to erroneously report zero in place of all values larger than Rs. 2.14 Crore (approx). Due to this, substantially lower Gross Exposure margin was collected while online limits remained unaltered.

6.49 According to SEBI the settlement data for the settlement nos. 148, 149 and 150 showed that the Gross exposure margin was understated in these settlements to the extent of the amounts mentioned below on the following days:

Date	Understatement of Gross Exposure Margin (Rs. in Crore)
1	2
27.02.2001	5.22
28.02.2001	13.45

1	2
01.03.2001	50.38
02.03.2001	9.23
05.03.2001	20.99
07.03.2001	16.99
08.03.2001	22.51

As would be seen from the above, the understatement of margin has varied from day to day and the maximum amount of gross margin understatement was Rs. 50.38 crore on 1.3.2001.

6.50 The extent of margin liability excluded from the calculation, due to the defect in software in respect of the defaulter brokers as reported by SEBI is as follows :

Rs. in crore		
Name of the Defaulter	Margin Due Date	Amount of Gross Exposure Margin not computed due to the bug
DK Singhania	1.3.01	11.10
Arihant Exim	1.3.01	13.17
Doe Jones	28.2.01	2.93
	1.3.01	5.02
Ashok Poddar	27.2.01	2.66
	28.02.01	4.23
	8.3.01	2.24
	13.3.01	4.28
HC Biyani	28.2.01	2.90
	01.3.01	2.80

6.51 The defect in the Gross Exposure Margin Module was detected after the payment crisis on 12.04.2001. CSE has stated that the defect has been rectified by CMC on 16.4.2001 and that CMC has been able to identify that the defect has been present in the Gross Exposure Margin computation since 15.12.1999. The margin module is stated to have been in operation from 26.02.1997.

6.52 Asked about his opinion on this deficiency in computer Software, the Chairman, Management Sub-Committee (Shri D. Basu) of CSE said during oral evidence:

“My own view is that we should have been able to pick up on random check basis at least where a high value transaction was taking place, where large transaction were taking place that if this is correct. I think, we should have done some re-verification ourselves.”

6.53 The witness also added: “We did not have enough system audit”. To a query as to whose responsibility was it to look after this aspect, the witness indicated that it was the responsibility of the Executive Director. The then Executive Director (Sh. Tapas Datta) however, pleaded: “Sir, I can only submit that I had no knowledge of this”.

6.54 In a post evidence reply, CSE has, however stated that “as the software module was developed and is being maintained by M/s CMC Ltd., the exchange holds the vendor responsible in this issue”.

6.55 Taking note of the fact that broker directors were benefited due to the error in the computer software, the Committee enquired whether the broker directors were not aware of the error in the computer system. In response, the former President of CSE (Shri Kamal Parekh) initially asserted “We had no knowledge whatsoever”. However, after persistent and probing queries by the Committee, he admitted that the brokers were aware that they were taking advantage of the error in the system. He, however, clarified that till they were on the Board, they were not aware that the brokers were taking advantage of margin error. Shri Ketan Parekh during his evidence before the Committee admitted that he availed of the advantage of faulty margin system in CSE. The Committee arrived at the view that low/non-collection of margin money lead to a large loss to CSE, that there was common knowledge if not active collusion by concerned authorities.

**(iv) Delay in deactivating terminals**

6.56 SEBI’s inspection of September 1998 stressed that the exchange should ensure that the margins are collected before the commencement of trading on the following day by directly debiting the margin liability to the members bank account. According to SEBI instruction of 2.7.1999, daily margins such as mark to market margin, volatility margin, carry forward margin etc., should be collected on T+1 day. Further, all the stock exchanges were advised by SEBI on 16.4.2000 to have connectivity with the clearing banks in order to ensure the efficiency of the collection of the margins. SEBI’s inspection report of October 1999 and September 2000 also required that margins should be collected strictly on T+1 basis.

6.57 SEBI’s inspection team has noticed instances where CSE has not deactivated the trading terminals of the brokers, who have not paid the margins on T+1, before the commencement of trading on T+2. CSE has been following a system of collection of margin wherein the cheques deposited are adjusted against margin liabilities of the members without confirming the realization of cheques.

6.58 Asked to explain the position in this regard, the former executive director of CSE stated during evidence : “In a large number of cases, cheques were received late evening and were banked on the next day morning and technically it becomes T+2”. CSE is, however, stated to have since introduced the system of direct debit.

6.59 The extent of delay in deactivating the terminals and further position built up in some of the cases reported by SEBI are shown below :—

Name of the defaulter	Date of first violation of exposure limit or non-payment of margin	Total position (as on)	Positions built up after the dates mentioned in Column 2	Actual date of deactivation of TWS	No. of trading days Delayed
1	2	3	4	5	6
D.K. Singhania	1.3.01	93.70 (1.3.01)	15.71	9.3.01 at 17.36 hrs.	6 days

1	2	3	4	5	6
Arihant Exim	1.3.01	96.6 (1.3.01)	16.92	7.3.01 at 18.36 hrs.	4 days
Doe Jones	1.3.01	57.35 (1.3.01)	37.60	8.3.01 at 20.09 hrs.	5 days
Tripoli Consultancy	23.02.01	49.06 (2.3.01)	42.46	9.3.01 at 17.36 hrs.	9 days
R.L. Poddar	26.2.01	17.93 (26.2.01)	5.63	7.3.01	6 dyas
R.K. Poddar	26.2.01	26.42 (2.3.01)	14.74	7.3.01	6 days
Prema Poddar	5.3.01	31.16 (5.3.01)	—	8.3.01	2 days
Ashok Poddar	27.2.01	81.19 (28.2.01)	5.32	7.3.01	5 days
H.C. Biyani	27.2.01	71.39 (27.2.01)	37.76	5.3.01	3 days
Biyani Securities	23.2.01	31.38 (1.3.01)	13.49	7.3.01	7 days

Total : 189.63

6.60 According to SEBI, CSE could have initiated appropriate actions such as deactivation of terminals or squaring up of positions on margin defaults or violation of exposure limits during the 10 days prior to the pay-in defaults and averted the crisis. SEBI Chairman held the view during oral evidence on 15.10.2001 that “this is a clear case of collusion”.

**(v) Delayed action on dishonoured cheques of margin payment**

6.61 CSE was not taking timely action on dishonoured cheques of margin payment.

6.62 Narrating the case of dishonoured cheques of margin payment by IndusInd Bank, CSE stated in a note as follows :

“On 10.3.2001 while making the pay-out one of the Clearing Bankers to the Exchange IndusInd Bank returned cheques worth about Rs. 16 crore, which were accounted for as margin paid by the defaulters to this Exchange after a gap of three to five days. Transfer cheques deposited on 5.3.2001 evening should have been automatically credited to Exchange account on the opening hours of 7.3.2001 (6th being a banking holiday) and transfer cheques deposited on 7.3.2001 should have been automatically credited to the Exchange account on 7.3.2001 itself. The Exchange took steps of writing to M/s IndusInd Bank on the issue in its letter dated 13.3.2001 (11th was Sunday).

The Bank in the case of these cheques did not follow the established practice that unpaid cheques should have been returned to the Margin Department of the Exchange and instead claimed to have contacted the President and Vice-President in presence of

Sri R.K. Bachhawat, Committee Member and held on to the cheques on their purported instruction.

It may be pertinent to note that had the Executive Director or the Exchange's Margin Department been alerted of the cheques dishonoured by the clearing bank *i.e.*, IndusInd Bank, earlier action of disabling the Trader Work Stations of the concerned brokers could have been initiated and thereby creating blockade in their capability to augment their outstanding positions which ultimately they could not sustain".

6.63 In its letter dated 13.3.2001 addressed to IndusInd Bank, CSE alleged that IndusInd Bank had suppressed the fact that the concerned brokers were not having sufficient funds in their account, with motivated intention to protect the interest of these brokers jeopardizing the interest of the exchange and demanded the bank to credit Rs. 15.30 crore. In response, IndusInd Bank wrote to CSE on 14.3.2001 informing that the bank's executive Mr. M. Subhabrata G. Roy contacted the Vice-President of CSE Mr. K.K. Daga on 7.3.2001 and also informed him over telephone regarding the shortage of funds in the accounts of the above mentioned brokers. Further, the bank has informed that Shri Subhabrata G. Roy was advised by the Vice President to meet the President along with the list of members who had shortage against margin cheques and when he contacted the President Shri Kamal Parekh in the presence of Shri R.K. Bachhawat (another committee member of CSE), he was advised to hold the cheque till further advice.

6.64 During oral evidence before JPC on 10.10.2001, reacting to the bank's above contention, Shri K.K. Daga (the then Vice President of CSE) asserted; "No, they did not contact me on that day". As a procedure, they should have contacted the Executive Director or the Deptt. concerned. Enquired whether the bank official contacted him on 7.3.2001, the then CSE President (Shri Kamal Parekh) said, "I do not really recollect". Shri R.K. Bachhawat, however, admitted that an official of the bank met Shri Kamal Parekh on 7.3.2001 and he was with him for about 10-15 minutes and that the bank official showed him (Shri Kamal Parekh) a slip. Shri R.K. Bachhawat, however, feigned ignorance of the contents of the slip and also as to what transpired between the bank official and the CSE President.

6.65 IndusInd Bank in its letter dated 3.4.2001 addressed to CSE stated that the bank had contacted the authorized signatories of the exchange the Vice President (Shri K. K. Daga) and the President (Shri Kamal Parekh) and there was no reason for the bank to contact any of the departments of CSE after getting specific instruction from the President of CSE.

6.66 The Committee noted that CSE had appointed all the nine broker directors including the President and Vice-President who were the Committee Members as honorary Treasurers of the Exchange for the year 2000-2001 and authorized them to operate all the bank accounts signing by any two of them and addressed a letter to this effect to IndusInd Bank on 1.11.2000. The Executive Director and the Secretary of the Exchange had also been given power to sign cheques and operate the bank accounts.

6.67 When asked whether SEBI was aware that the system in CSE provided that brokers themselves could operate the bank account of the Exchange, a representative of SEBI stated during evidence (16.10.2001) that according to Bye-laws, bank operation has to be with ED and one of the members of the Governing Board which could be the Treasurer or the President. When further enquired whether the bank account could be fully operated by the broker directors, the Chairman SEBI said that one of the signatories used to be a non-broker. He, however, admitted that the practice was unhealthy and assured that he would correct the system.

6.68 Asked about RBI guidelines regarding timeframe of intimation to customers about dishonoured cheques, the M.D., IndusInd Bank said, during evidence on 11.10.2001 :

“The RBI guidelines with respect to dishonoured cheque is that on a bank to bank basis, the actual physical cheques are required to be returned within 24 hours. When the situation is one involving a bank and a client such as in this case of CSE there is no specific RBI guidelines..... But there are some suggestions made by the Golporia Committee saying that in the event of dishonoured cheque, that cheque should be dispatched from the bank back to the client within 24 hours.”

6.69 Asked whether it could be inferred that the delay in informing CSE about the dishonoured cheques was to protect the interests of the concerned brokers, the MD, IndusInd Bank said: “No, that is not at all the case”. Explaining about the usual procedure in regard to return of dishonoured cheques received from CSE against margin money, the bank has stated in a post evidence reply that the details of all cheques not honoured by 5.00 P.M. are advised to CSE immediately by telephone and the dishonoured cheques are returned to CSE thereafter.

6.70 The Committee wanted to know whether criminal proceedings have been initiated against defaulted brokers in regard to dishonoured cheques, the Chairman, Management Sub-Committee (Shri D. Basu) said during evidence : “We initiated proceedings under Section 138 of the Negotiable Instrument Act”. Enquired whether any action has been taken against the brokers for cheating and breach of trust u.s 408, 409 and 420 of IPC, CSE informed in a post evidence reply that “the exchange authorities have filed FIRs with police authorities on 2.11.2001” against all the ten brokers of the three broking groups.

**(vi) Carry forward limit violations**

6.71 CSE, in July 2000, fixed the following carry forward trading limit for its Members and stipulated disciplinary action for not adhering to the prescribed limit :

Daily break up	:	Rs. 10 crore
Badla break up on Thursday (last trading day)	:	Rs. 5 crore

6.72 All the three defaulting groups in CSE are stated to have violated the Rs. 10 crore trading limit set up by the exchange around the period of “payment crisis”. Two groups namely A.K. Poddar and D.K. Singhania violated Rs. 5 crore carry forward limit on Thursday. During the settlement no. 131 to 150 (26.10.2000 to 15.03.2001) Ashok Kumar Poddar violated Rs. 10 crore carry forward trading limit 19 times in DSQ software scrip and 24 times in HFCL scrip. Prema Poddar violated 11 times in DSQ software and 18 times in HFCL scrip. Harish Biyani violated the limit 9 times in DSQ Software. Ratan Lal Poddar violated Rs. 10 crore c/f trading limit in HFCL 10 times and Raj Kumar Poddar 9 times.

6.73 Total number of violation member-wise in different scrips from settlement No. 131 to 150 (26.10.2000 to 15.03.2001) is observed to be as follows :

Name of Member	No. of violation
1	2
Ashok Kumar Poddar	64
D.K. Singhania	02

1	2
Doe Jones Investment	03
Harish Chandra Biyani	10
Prema Poddar	40
Raj Kumar Poddar	13
Ratan Lal Poddar	12
Total	144

6.74 When enquired what action was taken against the members for the violations, the then Executive Director (Shri Tapas Datta) said during evidence on 10.10.2001 : "In the case of Shri A.K. Poddar and Smt. Prema Poddar, we have written to them to ensure that there is no violation and in certain cases, if my memory serves me right, we have also deactivated the terminal for some time". When pointed out that Shri A.K. Poddar transgressed this rule 64 times, the witness said : "If it is 64 times, then definitely it is a slip-up".

#### **D. Trades outside the Exchange**

6.75 The transactions in the nature of spot deals under section 18 of the SC (R ) Act, can be entered into by persons outside the purview of Stock Exchange. Any other transaction which is not in the nature of spot deals and are done outside a recognised stock exchange is illegal. The SEBI inspecting team has observed that several matched trades, trading in circular pattern, position shifting and reversal of positions between groups of brokers in the CSE were generally transacted outside the exchange system and remained out side the purview of its regulatory supervision.

6.76 Shri Ketan Parekh during his evidence before the Committee stated that there were regular news articles on the official and unofficial badla rates in the financial dailies like the Economic Times and Business Standard. He also said that unofficial badla used to be quoted in news papers and that it was common knowledge.

6.77 SEBI's inspections of 1998, 1999 and 2000 urged CSE to streamline the system of reporting and recording of all the off-the-floor transactions and to ensure that all the off-the-floor transactions are considered for intra-day trading limit and other margins and exposure limit requirements.

6.78 Enquired whether SEBI was aware of the fact that unofficial badla was going in CSE, the Chairman SEBI said (15.10.2001) "we were aware of it that this kind of a thing was happening. We took action. On one occasion, nine brokers were punished because of this un-authorized carry-forward. Our own nominee director raised this issue..... But when we asked they said that a general kind of feeling is that just as black money exist in the country outside badla was there. But how do you detect this? We do not have police powers. We do not have the powers of search seizure."

6.79 CSE informed the Committee in a written reply that through market information and intelligence, CSE was aware of private deals between individuals, which is commonly described as illegal badla. The Exchange had carried out some inspection in 1999 and one of the brokers who was fined was Shri D.K. Singhania, Ex-President of CSE. The maximum fine which could be levied on the brokers was Rs. 25,000/- in accordance with the Articles of Association of the Exchange. It was felt that very paltry sum of Rs. 25,000/- as fine would not have any deterrent

value. In order to enhance the level of penalty the Exchange had proposed an amendment to its Articles of Association for removing the cap of maximum penalty. The said resolution, however, could not be passed at the Annual General Meeting held on 26.9.2000 because of opposition from members.

6.80 SEBI having been informed of this fact by CSE, issued a circular dated 24.1.2001 asking the exchange to amend the Articles/Bye-laws to remove the cap on penalty. Subsequently, SEBI issued direction on 12.09.2001 to CSE to amend the Articles to remove the cap on the fine and penalties. The said directive will be effective on the expiry of 60 days from the date of the order dated 12.9.2001. The Board of CSE discussed this issue at its meeting held on 3.10.2001 and approved the proposal to amend the Articles.

6.81 During the oral evidence of CSE held on 10.10.2001, the Committee desired the then members of CSE governing body to send their views in writing on the question of raising the limit of penalty. Out of 9 members, only three members (S/Shri Kamal Parekh, A. Khandelwal and Rajendra Kumar Agrawal) responded and they felt that the limit of penalty needed to be increased.

6.82 On the basis of its inspection during the period of October, 2000 and February 2001, CSE informed the Committee that there was indirect evidence to suggest that some of the defaulting brokers and few office bearers were involved in private financing deals (illegal badla). Asked whether any action was taken against the brokers involved, CSE stated in a post evidence reply dated 19.11.2001 that the Disciplinary Action Sub-Committee had decided to impose fines ranging from Rs.10,000/- to 25,000/- (maximum limit being Rs. 25,000/-) on 11 members and warned all the 12 members whose books and records were examined. However, in one case the member was suspended for one month for non-cooperating with the inspection department while carrying out the inspection.

6.83 Expressing a hope that illegal badla will be eliminated, CSE has stated in a written reply in June 2001 as follows:

“As the system of carry forward has been discontinued with effect from 2.7.2001 and rolling settlement has been introduced, it is expected that private financing or illegal badla will be eliminated.”

6.84 Certain newspaper reports appeared around December 2001, regarding re-emergence of unauthorized carry forward transactions at some exchanges. SEBI issued a circular on 31.1.2002 advising the exchanges to regularly examine orders and trades for identification of potential instances of unauthorized carry forward trades. SEBI's limited inspection of CSE in March 2002 revealed that CSE had identified some instances where trades were effected at prices widely different prices from the prevalent market price during that time. However, in only one case a broker had explained to the exchange that the trades took place due to oversight during transacting. No other action was reported to have been taken on any other member by the exchange. In this regard, the CSE Executive Director informed SEBI on 10.6.2002 that “though we have found few matching order between few brokers in few scrips but there are no corroboratory findings to establish unauthorized carry forward.”

#### **E. Sale of shares of DSQ Software to UTI**

6.85 The issues regarding sale of 13.30 lakhs shares of DSQ Software Ltd. by the CSE to UTI during the payment crisis are discussed under Part II of the report.

## F. Track record of CSE

6.86 It transpired during oral evidence of SEBI on 16.10.2001 that deficiencies in the working of CSE were not something new. The inspection of CSE in November, 1992 had found that CSE was not having a mechanism for monitoring margins payable and had found out many of the defects in the working of CSE. It was recommended that governor/board of the exchange should be suspended. SEBI ordered an inquiry into the affairs of CSE in 1994. One of the recommendation of the inquiry report was that the permanent recognition of the exchange should be withdrawn and that the exchange should be asked to function on an annual recognition basis till the date corrective systems are put in place. Explaining the action taken by SEBI in this regard, SEBI Chairman stated:

“The SEBI Board considered the inquiry report in May, 1994 and decided that a show cause notice be issued to the CSE under section 11 of the Security Contract (Regulation) Act. On 20.7.1994 the then Chairman of SEBI granted a hearing to the President and the Executive Directors of the CSE. Both in their reply to the show cause notice and in the hearing said that they were willing to take corrective measures. The matter was kept in abeyance for some time. In November, 1994, the SEBI Board reviewed the corrective measures taken by the CSE in respect of the findings of the enquiry. The Board took note of the steps taken by CSE and expressed satisfaction over the same. No further action was taken”.

6.87 A mere review and promise by CSE functionaries satisfying SEBI must be considered the first step to giving CSE a feeling that serious mistakes will be overlooked by the Regulator.

## G. Conflict of Interest

6.88 SEBI's inspection of CSE in September 1998 observed that elected board members of the exchange were interfering in the day-to-day matters of the exchange. Some instances of interference in the routine administrative matters of Exchange are given below :

- (i) Instances where the President or Vice President had issued directions to the Surveillance staff to reactivate members' terminal are as follows :

Date	Member's Name	Remarks
13.8.97	Archana Khandalval	TWS switched off on 13.8.97 at 12.23 pm for Rs. 20.69 lakhs Daily Margin due of 11.8.97 but reactivated at 01.00 pm under Vice President's advice that the member will deposit the shares. The member had deposited the shares on 14.8.97, which was returned on the same day and subsequently re-deposited on 16.8.97.
1.9.97	S.K. Goenka & Co	TWS reactivated on 1.9.97 under advice of President.
1.12.97	Ganpatray Kayan	As per order of the President member will not do any transaction but watch Touchline and reactivate it.
4.3.98	M. Jalan & Son	TWS reactivated at 18.01.00 for square off as per President's Order.
18.6.98	M. Jalan & Son	TWS reactivated at 17.05.01 as advised by the President.

- (ii) It has been observed that in the event of pay-in default, the pay-out is completed with the instruction from the President.
- (iii) President's approval is required for withdrawal of securities above Rs. 5 lacs kept towards Base Minimum Capital.
- (iv) It has been noticed that on the instructions of the President, security deposit of N.K. Modi & Co was released on 15.7.97 though the case was referred to Members' & Assistant Sub-Committee, afterwards and decision for withdrawal was taken by the Committee on 28.8.98.
- (v) Instances were noticed where relaxation was granted to the board members like D.K. Singhania Ex-President who was permitted to exceed the intra-day trading limit and allowed to withdraw the incremental capital before expiry of one month. Further, in the case of board member Mehta & Ajmera, who have frequently defaulted in pay-in, the fine imposed for delay in making Pay-in (Rs. 1.23 crore) towards settlement No.1 was waived.

6.89 It has also been observed that the exchange officials at various levels have not been given adequate decision making authority to discharge their day-to-day basic functions effectively and even for the routine decisions like deactivation of terminals in case of non-payment of margin, imposition of fines as per exchange's circular, action in case of shortfall of Base Minimum Capital, etc. officials have to obtain prior approval of President/Executive Director.

6.90 The Executive Director is responsible to run the day-to-day administration and to enforce the Articles, By-laws, Rules and Regulations of the Exchange as well as to give effect to the directives, guidelines and orders issued by SEBI. However, SEBI's inspection of CSE in October 1999 has observed that the Executive Director had power to impose penalty only upto Rs. 1000 and or suspension of member from doing business for a period not exceeding seven days in case of violation of the Articles, Bye-laws and Regulations of the Association and non compliance of his directions, orders etc. The Executive Director also did not have power to incur any capital or revenue expenses. It would be very difficult for an Executive Director to have control over the members and run day-to-day affairs of the exchange under such circumstances.

6.91 Citing lack of freedom to the ED as a major factor that was responsible for the state of affairs in CSE, the then ED owned up that he could not go by the best possible judgement of his own and pleaded for demutualisation of the stock exchanges as follows:

"Sir, let me explain in brief, the environment in which I have to work. Needless to mention that though decision making authority is the Governing body comprising of nine elected broker-directors and other nine from outside, virtually it was elected members who dominated the Board. There were very few occasions when all the nine non-elected directors were present. Naturally, the elected directors dominated the decision making process and Executive Director remained a silent spectator. The infirmities of environment are well known to all the competent authorities of the capital markets of the country. Despite the best efforts and all sincere assistance extended to me by SEBI, I own up to the fact I could not go by the best possible judgement of my own. You may perhaps have observed that immediately after the irregularities surfaced, SEBI took the first decision to remove the elected members of the governing board of BSE. In case of Calcutta Stock Exchange the elected directors themselves resigned. Today, I feel that I have the freedom to work under the guidance of the Management Committee and with their cooperation I can apply the best of my judgement to tackle the situation.... Since the tentacles of the above environment vitiated every lane and bye-lane of the Exchange all my efforts in various areas particularly for the safety of the market were in vain.

Sir, I would like to submit that despite my honest intentions I could not translate my desire into action primarily because of the indirect pressure of elected directors who as a matter of fact wielded enormous influence on the decision making process of the governing board. Without making any insinuation against any individual it follows that the Executive Director could not take independent decisions which could have adversely affected influential members nor could he insulate executives whose service condition was largely decided by the elected directors.

I humbly pray, the process of demutualisation is accelerated and implemented and the executives of the Stock Exchanges of the country can function in a healthy corporate culture."

6.92 Asked whether SEBI had given any direction for the removal of Shri Tapas Datta, the witness said :

"We did not get any direction from SEBI that he should be sacked. After all, when we talked, SEBI representatives were also in the Board and we get a sense of what was going on. After all, there was not one reason. There was a combination of several factors, which persuaded the Board Committee to take the decision".

6.93 In March 2001, all nine elected broker directors resigned from the office. From then, the Management Sub-Committee consisting of Public Representative Directors and Executive Director only is looking into the operations of the Exchange as per the information furnished to the Committee by CSE on 2.5.2002.

6.94 The Committee find that the payment problem in CSE in March, 2001 was primarily due to high concentration in a few scrips by a few brokers and a general failure of the Exchange in terms of surveillance and risk management. These in turn owed their existence to the weaknesses in the system due to conflict of interest in the case of broker Directors. The total pay-in default of Rs.120 crore during the crisis was met by utilising the Settlement Guarantee Fund and from other resources of the Exchange. This is stated to have impacted the reserves of the Exchange to the tune of Rs.11 crore. Although SEBI has claimed that all investors got their due amount or securities on time and that there was no possibility of any adverse impact in real terms on other Stock Exchanges or the overall Stock Market, the Committee note that the payment crisis did affect market sentiment all over the country. As is evident from the succeeding paragraphs of this section, there has been obvious laxity in surveillance and gross violation of exposure controls and risk management measures. Payment crisis in CSE was not an isolated incident. It must be viewed from the overall manipulations of stock markets in India by various players of which Calcutta brokers became surrogates. These players included key brokers, corporate houses behind the brokers and broker directors of CSE. The payment crisis in CSE is due to wilful inaction of CSE and SEBI and involvement of banks.

6.95 The Committee cannot but express its dismay at the way the stock watch surveillance system was rendered largely ineffective since June, 2000 by the steep upward revision of the bench mark for generation of alerts from the trade size of 20,000 to 90,000. Further, even the few alerts generated by the surveillance system in case of volatile and active scrips were either ignored or not pursued seriously by the CSE and no pro-active role was taken by the CSE to find out the nature and likely impact of Members' matching trade and shifting of positions in circular fashion. Thus, the CSE crippled the surveillance mechanism and facilitated brokers to prefer concentrated positions in certain scrips.

6.96 The Committee find that the CSE had been permitting its members to violate the exposure limits and avoid margin payment, thereby defeating the very purpose of the risk management systems. According to SEBI, CSE could have prevented the "payment crisis", had it strictly followed

the SEBI directives on margins and exposure limits. The gross exposure limits were violated in two ways. By the first method, the CSE's computation of gross exposure used to exclude the long position crystallised at the end of the previous settlement in violation of SEBI's instruction of 2.7.1999. The case of non-inclusion of crystallised delivery to the tune of Rs.161 crore on 1.3.2001 in respect of one broker illustrates the extent to which the gross exposure by brokers exceeded the limit. By the second method, while computing gross exposure limits of the brokers, CSE was avoiding deduction of the additional capital which had been utilised against marginal liability. Consequently, violation of exposure limits by some brokers on this account ranged between Rs. 48 crore and Rs.109 crore prior to their pay-in default. Such wilful violation of risk management systems cannot be accepted from any quarter.

6.97 The margin money collected by CSE on gross exposure of brokers was substantially lower than the required amount due to a software error. The programme module used to erroneously report zero in place of all values larger than Rs. 2.14 crore (approx.). The under statement of gross exposure margin varied from day to day and it was as much as Rs. 50.38 crore on 1.3.2001 out of which the under-statement pertaining to one defaulter broker alone was to the tune of over Rs.11 crore. The brokers including broker directors were aware of the software error and avoided reporting the matter to the Exchange. This reveals the collusion and connivance among all concerned. The Committee cannot accept the then Executive Director's plea that he had no knowledge of the error which had been prevalent since December, 1999. The Committee, therefore, recommend that this be thoroughly investigated and appropriate action taken.

6.98 The estimation of margins was made by the margin module of C Star software developed and maintained by CMC Ltd. Though the defect has been rectified by CMC on 16.04.2001, the Committee feel that the extent of the responsibility of CMC and others for the software error needs to be investigated.

6.99 Though the Exchange was supposed to deactivate the trading terminals of brokers who had not paid the margins on T+1 basis, CSE delayed the deactivation of their terminals. The delay ranged from 4 to 9 days in eight cases and had enabled the brokers to build up further positions to the extent of Rs.190 crore. The Committee agree with the then SEBI Chairman that this was a clear case of collusion. Though SEBI has been emphasising in its annual inspection reports right from the year 1998 that CSE should have connectivity with the clearing banks for a system of direct debit, CSE is stated to have introduced the system of direct debit only after the 'payment crisis'.

6.100 The Committee are astonished to note that the CSE had appointed all the 9 broker Directors as honorary treasurers and authorized them to operate all the bank accounts signed by any two of them. This arrangement was bound to lead to corrupt practices. The Committee hope that as assured by SEBI, steps would be taken to correct the system.

6.101 Another area in which CSE failed miserably is in enforcing its own rules concerning the trading and carry forward limits. Though the CSE had fixed trading and carry forward limits, these were violated with impunity. All the defaulting groups had violated trading limits set up by the Exchange around the period of the payment crisis. The number of violations was as high as 144 during 20 settlements, out of which one member alone accounted for 64 instances of violation. However, no disciplinary action worth the name had been taken against any of the violators under the rules of the Exchange.

6.102 Yet another area which contributed to the payment crisis in CSE was private deals between individuals, commonly known as 'illegal badla' which remained outside the purview of regulatory supervision of the Exchange. The Committee note that SEBI has been emphasizing in

all its inspection reports that CSE should streamline the system of reporting and recording of all the off the floor transactions. However, no meaningful action had been taken by the Exchange nor had SEBI ensured implementation of its suggestions. The Committee deprecate the indifference on the part of both the Exchange and the regulator. The Committee feel that SEBI wilfully overlooked the irregularities committed in this regard. Incidentally, the power of CSE to impose fine on the offenders in this regard was a paltry amount of Rs. 25,000/-. The efforts of the Exchange to enhance the level of penalty met with stiff resistance at the Annual General Body Meeting held on 26.9.2000. It was only on 12.9.2001 SEBI issued direction to CSE to amend its Articles of Association to remove the cap on the fine and penalties.

6.103 Looking at the future, illegal financing in various forms appear to be resurfacing in stock exchanges like Ahmedabad. Synchronized deals and gathering of brokers at a fixed time on a particular day in a week in trading hall of the exchange/corridors of the exchange to fix badla charges is common knowledge. There is need for SEBI to take immediate action. Also, some large and influential brokers of BSE/NSE appear to have recently started funding their clients and other operators taking shelter under a specific circular of SEBI incidental/consequential to their securities business. SEBI needs to come out clearly on such transactions. SEBI should crack down immediately on such modes of financing which is getting prevalent across the country. Otherwise crisis of the CSE type will re-emerge on BSE, NSE, Ahemdabad and other stock exchanges soon.

6.104 The Committee are concerned to learn that the deficiencies in the working of CSE were not of recent origin. SEBI's report a decade ago had found numerous deficiencies including absence of a mechanism for monitoring margins. On the basis of an enquiry into the affairs of CSE in April, 1994, it was recommended that the Board of the Exchange should be suspended. The problems of CSE as seen by this Committee appear to flow from the culture of non-compliance with rules, regulations and transparent practices. This appears to have developed over a period of time. In 1994 it was recommended that the Board of the Exchange should be suspended because of gross malpractices. After reviewing the position, however, the SEBI did not suspend the Exchange or take any severe measures as to shake up work culture of the exchange. The Committee's examination has, however, shown that nothing changed in CSE. Instead, things went from bad to worse. It is clear that despite knowing the track record of CSE, SEBI did not take timely corrective action. The Committee are of the view that SEBI should have played a more proactive role in the affairs of CSE and curbed malpractices well in time. The SEBI failed to do so. Officials of Surveillance Department of SEBI dealing with CSE are also similarly responsible. SEBI's lapses should be investigated and accountability be fixed.

6.105 It was the responsibility of the Executive Director to run the day-to-day administration and to enforce the Articles, Bye-laws, Rules and Regulations of the Exchange as well as to give effect to the directives, guidelines and orders issued by SEBI. The Committee note that the Executive Director, however, did not have adequate powers to control the members and run the day-to-day affairs of the Exchange, and there had been interference by the elected board members in the day-to-day matters of the Exchange. The Committee feel that the remedy for the ailment of the Exchange is demutualisation. This would also enable strengthening of the regulatory and supervisory framework of the Exchange and would go a long way in the protection of investors. The Committee stress that urgent measures need to be taken in this direction.

6.106 The Committee, *inter-alia*, recommend the following:—

- (i) After determining the extent of their involvement, appropriate criminal penal action should be taken against the defaulting brokers, especially those who were broker-Directors of CSE, for exposing the investors and the Exchange to grave risks by their

criminal negligence/deliberate failure to initiate steps for rectification of short collection of gross exposure margin by the Exchange, despite their personal knowledge about the fraud.

- (ii) A thorough investigation against the then Executive Director be instituted and completed within three months to determine his criminal negligence and dereliction of duty in the affairs of the Exchange that led to major failure of the CSE. On the basis of outcome of the enquiry, suitable action be taken forthwith.
- (iii) SEBI should remain vigilant to ensure that illegal financing does not restart in various Stock Exchanges.

## 2. MATTERS REGARDING OTHER STOCK EXCHANGES

### A. Surveillance Committee in BSE

6.107 A Governing Board comprising nine elected Directors (one-third of them retire every year by rotation), an Executive Director, three SEBI nominees, Reserve Bank of India nominee and five public representatives, is the apex body which regulates the Stock Exchange Mumbai (BSE) and decides its policies. A President, Vice-President and an Honorary Treasurer are annually elected from among the elected Directors, by the Governing Board following the election of Directors. The Executive Director as the Chief Executive Officer is responsible for the day-to-day administration of the Exchange. The composition of the Governing Board as on 31.3.2001 is given in Appendix VIII.

6.108 The BSE has a separate Surveillance Department to keep a close watch on price movement of scrips, detect market manipulations like price rigging, etc, monitor abnormal prices and volumes inconsistent with normal trading pattern and monitor the member brokers position to ensure that defaults do not occur. A Surveillance Committee was constituted by the Governing Board of BSE on 25.5.2000 to advise and assist the administration to improve the Surveillance System of the Exchange. The Committee consisted of three independent Directors and two elected Directors. The President of BSE was the ex-officio Chairman of the Committee. The Committee enquired why the Broker Directors and Governing Board Members are associated in the Surveillance Committee. In response, the former president of BSE (Shri Anand Rathi) stated during evidence that "all the circulars are addressed to the President of the Stock Exchange. The circulars also specify that it is the responsibility of the President and the Executive Director to see that these are complied with. Our belief all along has been that if the President of the Stock Exchange itself is a broker and the Governing Board is supposed to look after the surveillance function also, as a part of overall responsibility, then, I think, there is nothing wrong in the brokers being involved in that."

6.109 SEBI issued a circular in August 1995 *inter-alia* stating that the stock exchanges shall have separate surveillance departments which will be directly under the Executive Director of Stock Exchange or senior most official of the Stock Exchange in his absence with a view to insulating the surveillance system from broker office bearers and broker Directors. However, SEBI issued a directive on 17.8.1996 that Governing Boards of the Exchanges should review the functioning of their surveillance department at every Board meeting and reiterated this position in its letter dated 25.5.2000 addressed to Stock Exchanges.

6.110 Asked about the reasons for not holding any meeting of Surveillance Committee since its constitution on 25.5.2000 and suddenly holding two meetings in quick succession on 11.1.2001 and 23.1.2001, the then President of BSE, (Shri Anand Rathi) stated :—

"Sir, as far as I remember, there were no adverse reports about Surveillance during May to December. If I remember correctly, the first meeting was held to find out what exactly they (Surveillance Department) are doing and whether that needs to be changed in

order to concentrate on more important things rather than wasting time on smaller things..... The second meeting, in fact, was held because in the first meeting, the data was not fully available. The Department was asked to compile the data. The data was presented in the second meeting. It took some decisions and gave directions that this was how it could be handled.”

6.111 Enquired whether the Surveillance Committee detected any lacuna in the system, a public representative Director said:

“Enquiries were started in hundreds of cases and they were not getting completed. So, in order to make it effective, we decided that we should find out which are the grave cases of manipulations where the enquiry should be started.”

## **B. Surveillance Information in BSE**

6.112 Shri Anand Rathi was a broker director and was holding the office of the President of BSE on 2.3.2001, on the day sensex came down by 176 points. Shri Anand Rathi, the then President of BSE had obtained certain trade related information from Shri Arun Dhanawade, Assistant General Manager in the Surveillance Department of BSE. Following disclosure of this information the then President of BSE submitted his resignation on 7.3.2001. It was accepted by the Governing Board on 8.3.2001. The Members of the Governing Board expressed their complete confidence in the integrity of Shri Anand Rathi and appreciated the excellent work done by him as the President of the Stock Exchange.

6.113 When asked whether passing such an appreciative resolution would tantamount to pre-empting an inquiry against Shri Anand Rathi and handing him over a clean chit, the ED, BSE said, “the Board has discussed about this. While passing the resolution, all the Board Members applied their mind. Then only, they passed this resolution unanimously.”

6.114 A representative of SEBI, however, informed during BSE evidence that SEBI nominee director (Shri L.K. Singhvi) had disassociated himself from that resolution. Clarifying the position in this regard, a public representative director of BSE (Justice D.R. Dhanuka) mentioned that he received a letter dated 5.7.2001 from the SEBI nominee director nearly four months after the said meeting and the letter read as follows :

“I have obtained the minutes of the Board meeting of 8.3.2001 from you now and I find that the Resolution appreciating the good work and expressing confidence in the integrity of Shri Rathi has been recorded in the minutes. However, inadvertently it has not been mentioned that I had abstained from this decision.”

The public representative director, however, disagreed with the contents of the letter and said that there was unanimity in the meeting of 8.3.2001.

6.115 Enquired whether the kind of conversation between Shri Anand Rathi and Dhanawade unusual, the ED, BSE (Shri A.N. Joshi) said, “This was not a usual type of conversation.” To a query whether the issue regarding the conversation between Shri Anand Rathi and Shri Dhanawade placed before the Governing Board for its consideration the ED, BSE said, “I did not consider to bring the issue before the Governing Board.”

6.116 Shri A.A. Tirodkar, the then Director of Surveillance, BSE deposed before the Committee that Shri Anand Rathi had several times asked for information in the past about the status of the market. He said such instances were more than five times over a period of one year and that he had reported this fact to the Executive Director (Shri A.N. Joshi). Asked what action was

taken by him in this regard, the ED stated that on one or two occasions in the past Shri Tirodkar informed him generally. He, however, did not consider this limited enquiry by Shri Rathi from Shri Tirodkar as objectionable.

6.117 Shri Tirodkar stated that the information Shri Anand Rathi used to ask was about who was buying and who was selling and "any one who has that knowledge can make tremendous amount of money by joining the same current." The ED, BSE also admitted during evidence that the information about who was buying and who was selling was "sensitive."

6.118 When the Committee pointed out that in other Stock Exchanges in the world a convention has developed where a broker when elected as President volunteers that during his term of office would not do any trading, a former broker director (Smt. Deena Mehta) said "In the present Board all of us have declared that we do not do proprietary trading."

6.119 SEBI got to know on 6.3.2001 that some of the elected Directors of the Stock Exchange, Mumbai might have obtained price sensitive information about certain scrips and member's position from the surveillance department of the Exchange. SEBI passed an order on 12.3.2001 restraining Shri Anand Rathi from acting as a director member of the Governing Board of the Stock Exchange and also directed Shri Anand Rathi and his four concerns not to undertake any fresh business as a broker till further orders are passed by SEBI. SEBI's investigation confirmed that the information obtained by Shri Anand Rathi was price sensitive.

6.120 SEBI engaged an independent agency—M/s. Ernest & Young Pvt. Ltd. to investigate into trades of Rathi Group. The agency analysed the trades of Rathi Group and the trades of 33 related entities of Anand Rathi and opined that the information as acquired by Shri Rathi from Shri Arun Dhanawade on 2.3.2001 was not used by the Rathi Group for making a profit or/ and avoiding losses.

6.121 Pursuant to the Enquiry Proceedings, SEBI debarred Shri Rathi for a period of 2 years and suspended the entities pertaining to Shri Rathi for a period of 9 months. However, Securities Appellate Tribunal modified the order and debarred Shri Rathi for a period of one year from 12.3.2001 from holding any position as a member of the Governing Board or office bearer of any Stock Exchanges.

6.122 When Shri Anand Rathi obtained price sensitive information from the surveillance department on 2.3.2001, six others including three member directors were present. SEBI passed an order dated 12.3.2001 and 28.3.2001 restraining these members from acting as directors of the governing board of the Exchange. SEBI's investigation, however, concluded that apparently, there was no evidence to establish that the broking firms of these members had used the information for their benefit, their firms or clients.

6.123 It transpired during oral evidence that a copy of tape recorded conversation between Shri Anand Rathi and Shri Arun Dhanawade was taken outside the Exchange by Shri Tirodkar. He was also alleged to have leaked the sensitive information to unauthorised entities. Asked about the necessity for taking a copy of the audio tape, Shri Tirodkar said that "there was a connection between the Executive Director and the President and information was passed on. I cannot prove it. The first time I found (evidence) I immediately took action of preserving this one and ensured that it went to the right authority."

6.124 The Committee enquired whether the irregularity committed by a person for having leaked the information to the BSE President is less serious than the irregularity of having taken a copy of the tape unauthorisedly. In response, the executive director of BSE stated in a written

reply that if one closely looked at the circumstances under which Shri Arun Dhanawade had given the information to the President and its immediate disclosure by Shri Dhanawade to his superiors as against the circumstances where, in a premeditated manner, Shri. A.A. Tirodkar unauthorisedly took a copy of the tape for allegedly leaking it to the press, in gross violation of the prevailing instructions, one would come to the conclusion that no parallel could be drawn between the two incidents.

6.125 BSE initially instituted an investigation by an in-house Committee against Shri Tirodkar and later the Governing Board of BSE instituted an independent inquiry by a retired Bombay High Court Judge Justice B.V. Chavan. The enquiry report exonerated Shri Tirodkar in respect of five charges and held him guilty in respect of two charges viz. failure to hand over the tape after 12/3/2001 and failure to record presence through Biometric System. The Enquiry Officer has held that the two charges that have been established cannot be said to be serious misconduct inviting dismissal, nor it can be said that proof of these charges should result in loss of confidence inviting Termination Simpliciter. The enquiry officer recommended that Shri Tirodkar may be allowed to resume his duties as Secretary of the Exchange but not to entrust to him any other responsibilities in view of his delicate health condition. The enquiry officer also suggested that in case the Governing Board takes a conscious view that the services of Shri Tirodkar are no more useful to the Exchange, it would be open to the Governing Board to terminate his services on payment of terminal benefits and six month's pay.

6.126 On the basis of findings of the Enquiry Committee, the Governing Board on 19.4.2002 took a conscious view that services of Shri A.A. Tirodkar are not and shall not be useful to the organization and it was in the interest of BSE that his services be terminated as suggested/recommended by Hon'ble Justice B Chavan. The BSE has informed JPC through its letter dated 27.8.2002 that its Governing Board has decided to offer a personal hearing to Shri Tirodkar on 13.9.2002 and review its earlier decision on merits and in accordance with law.

### **C. ALBM in NSE**

6.127 National Stock Exchange (NSE) promoted by financial institutions (FIs) was incorporated in November 1992 as a tax-paying company. The composition of Board of Directors of NSE is given in Appendix IX. During the year 2000-2001 NSE had a market share of 59.3% in the Wholesale Debt Market (WDM) segment, 45.3% in the Capital Market (CM) segment. The year 2000-01 witnessed a total turnover of Rs. 17,70,457 crore against a turnover of Rs. 11,43,268 crore in the preceeding year. The annual growth rate of turnover of NSE over five years from 1995-96 to 2000-01 has been 86%.

6.128 NSE had some defaulters during the payment crisis of CSE in Feb.-March, 2001. But the settlement system had not shown any problem. The corpus of the Settlement Guarantee Fund (SGF) in NSE was large enough to absorb defaults as the Fund stood at Rs. 2,916 crore as at the end of March, 2001. The total pay-in shortfall in NSE in four settlements No. 7 to 10 on 27.2.2001 and on 5.3.2001, 13.3.2001 and 20.3.2001 amounted to Rs. 115.16 crore. The shortfall was met from the SGF. NSE has subsequently recovered Rs. 106.32 crore from the Members. Net utilisation from SGF in respect of the four settlements of Feb.-March, 2001 is Rs. 8.84 crore.

6.129 National Securities Clearing Corporation Ltd. (NSCCL), the clearing arm of NSE obtained registration as approved intermediary under the Securities Lending Scheme, 1997 (SLS) in November, 1998 and started Automated Lending and Borrowing Mechanism (ALBM) under SLS in February 1999. The ALBM scheme was subsequently modified by NSCCL in December 1999. The ALBM turnover was negligible and was around Rs. 10 crore till March 2000 which increased to Rs. 700 crore in April 2000 and thereafter. All deferral products including ALBM was discontinued w.e.f. 2.7.2001.

### **(i) Risk features**

6.130 According to SEBI, the modified scheme was not a pure stock lending scheme but a hybrid product which incorporated features of both stock lending and deferral of positions. However, it did not have risk management measures which are normally associated with the deferral products such as Modified Carry Forward System (MCFS). The main concerns with respect to deferral products has been (a) the possibility of a ballooning of deferral positions; (b) potential misuse of securities borrowed to sell on other markets and depress prices and (c) selection of appropriate securities.

6.131 Based on certain points concerning ALBM raised by BSE, SEBI constituted a Group in May 2000 under the Chairmanship of Prof. J.R. Varma, Member, SEBI Board to address these issues on the basis of the recommendations of the Group. SEBI allowed ALBM to be introduced in July 2000, by stock exchanges as a generic product and also prescribed the risk management system which was common in most respects with that of MCFS except the withdrawal facility of shares financed in ALBM. One of the terms of reference of the Varma Group was to determine whether the modified ALBM introduced by NSCCL was in conformity with SLS 1997. The Group in its report submitted in July, 2000, however, indicated that this issue would be covered in Part II of the report. The Part II of the report has not however, been submitted so far.

### **(ii) Approval for modified ALBM**

6.132 The approval framework for ALBM provided that operating guidelines framed under Securities Lending Scheme were required to be forwarded to SEBI at least one working day prior to implementation. Certain changes were proposed in the ALBM by NSCCL in its letter addressed to SEBI on 26.10.1999 and the modified scheme was made operational after two months on 29.12.1999.

6.133 Introduction of a deferral product similar to MCFS requires prior approval of SEBI. Although the modified ALBM introduced in December 1999 had the features of deferral product, it was granted formal approval by SEBI only after nine months in October 2000. It raised a question whether the operation of modified ALBM during the intervening period from December, 1999 to September, 2000 was legal. In order to ascertain facts in this regard, the file in original concerning ALBM was obtained by JPC from SEBI.

6.134 It is observed from SEBI's file that ED (Law) of SEBI quoted a legal opinion in this regard and recorded the following note on 11.2.2002 :—

"It is clear from the records that SEBI was informed of the modifications by NSCCL in the month of October, 1999 and December, 1999. SEBI has not stopped the scheme or directed NSE to seek prior permission. Even after the Prof. J.R. Varma Committee report, the circular issued by SEBI speaks of only one permission. Even at that stage, it was not suggested by SEBI that separate permission would be required for carry forward which will be distinct from ALBM. In view of the above, in my opinion, it cannot be contended that ALBM (between December, 1999—July, 2000) would require a separate and distinct permission or that SEBI could treat it as a violation.

...The above opinion was perused by the Senior Standing Counsel (Shri Rafique Dada) and he further added that "in view of the fact that SEBI was made fully aware of the scheme by NSE in October and December and the fact that only one permission was granted in July by SEBI, would indicate that no two permissions were perceived by SEBI to be required. Therefore, any action on this issue would not be correct."

6.135 Opinion of Solicitor General of India was also obtained by SEBI in this regard. He has opined that on the facts, NSCCL did not require a fresh permission from SEBI for starting the modified ALBM scheme from December/January 2000. He has further opined that NSCCL has not violated the Securities Lending Scheme guidelines of SEBI nor did NSCCL violate RCFS/MCFS circulars of SEBI and NSCCL did not require prior permission from SEBI before operating the modified ALBM Scheme. SEBI has stated that in view of the above, the modified ALBM scheme did not require the prior approval of SEBI for operating it from December 1999/January 2000 and hence had legal sanctity.

### **(iii) Withdrawal of Securities under ALBM**

6.136 During the period April 2000 to March 2001 the total turnover in normal segment at NSE was around Rs. 12,50,000 crore and total ALBM turnover was around Rs. 85,000 crore. The latter was 6.8% of the total NSE turnover. In the ALBM, the pure securities borrowers had the option of depositing the collateral with the clearing corporation or may opt for withdrawing the shares from the clearing house/clearing corporation subject to margins whereas in case of MCFS, it was mandatory that the shares against Vyaj Badla have to be kept deposited with the clearing house. The rationale for allowing withdrawal of securities under ALBM was stated to be that since a member could be using the ALBM to borrow securities to meet obligations outside the NSE/NSCCL system, it would not be feasible to mandate that all financier shares should be compulsorily deposited with the clearing corporation.

6.137 There were allegations of misuse of ALBM by withdrawing securities against pure borrow transactions. In February 2001, the option given to the pure securities borrowers for withdrawal of shares from the clearing house/clearing corporation was withdrawn. In order to examine whether the facility of withdrawal of securities under ALBM was misused, SEBI undertook an exercise at the instance of the JPC. SEBI's analysis brought out the following :—

- *In the ALBM scheme Reliance Shares and Stock Broker Ltd. (RSSBL) was the major participant, who comprised 39% of the total ALBM volume during the period April 2000 to March 2001. Further, the broker comprised 65% of the total pure borrow transactions in ALBM in the period Oct. 2000 to March 2001. Therefore, the examination of ALBM at NSE was restricted to transactions of RSSBL and its main client, Reliance Petroleum Ltd.*
- *It was only from October 2000, NSE provided facility for identification of pure borrow transactions and retention of shares received as collateral with the Clearing Corporation.*
- *In the period April 2000 to Sep. 2000, brokers could withdraw shares from the Clearing Corporation as there was no facility for retaining them. In this period it was seen that even though shares were received as collateral against pure borrow by the broker RSSBL, these shares remained in the beneficiary account of the client (mainly Reliance Petroleum Ltd. who accounts for 96% of the total RSSBL trades) till they were returned to the broker RSSBL.*
- *During the period mentioned above, the broker, RSSBL made more purchases than sales. Further compared to the total cumulative ALBM volumes of the broker RSSBL of Rs. 33,287 crore in this period, the sale/purchase by the member at NSE is very small.*

In view of the above, SEBI concluded that the facts and figures did not bear out that the ALBM facility was misused or manipulated by withdrawing the borrowed securities and using them again by way of selling, pledging, etc.

6.138 Incidentally, it is also observed from SEBI report that the aggregate value of securities withdrawn by all brokers in all ALBM sessions from October 2000 to February 2001 was only Rs. 390 crore against total ALBM turnover of around Rs. 50,000 crore during this period. NSE also submitted that during October 2000 to February 2001, withdrawals of pure borrow securities in ALBM have been minimal and were not available for reselling. Further, the stringent system of margins and position limits on deferred positions implemented from August 2000 and gross margining at client level from October 2000 effectively limited the capacity of any single broker to take unduly large deferral positions. NSE submitted that in its assessment, ALBM was not responsible for the problems of the market that were witnessed in March, 2001.

#### **(iv) Financing of ALBM**

6.139 According to SEBI, Reliance Shares and Stock Brokers Ltd. (RSSBL) was the top-most participant at NSE in ALBM and at BSE in BLESS. The amount of funds deployed by them in ALBM, BLESS and Vyaj Badla financing in CSE around the end of February 2001 was to the tune of Rs. 1900 crore. These funds were withdrawn from the market between 28.2.2001 and 7.3.2001 and was reduced to Nil.

6.140 The Committee desired to know whether withdrawal of huge funds from the market on such a scale would not adversely affect the market. The Chairman, SEBI admitted during oral evidence that if funds were withdrawn on such a large scale, it could certainly influence the share prices. SEBI, however, clarified in a written reply that the huge withdrawal of funds under the ALBM by a single entity cannot by itself be considered as illegal. It is only when huge withdrawal of funds would be coupled with some other activity or any other act which would fall under the provisions of the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 1995 or some other Regulations, the withdrawal of funds would be said to be illegal.

6.141 Shri Ketan Parekh, Stock Broker stated in this connection in a written reply that the withdrawal of large funds from the market would affect the market. It would also increase the costs of carrying forward positions. He stated further that "supposing 2000 crore was withdrawn in a span of ten days in February-March 2001, it is inevitable that the bulls had to either liquidate their positions or take delivery".

6.142 Explaining the reasons for withdrawal of funds from ALBM, the Reliance Petroleum has reportedly stated that "our peak investment in ALBM segment was approximately Rs. 1600 crore. We brought down our investment to Nil in March 2001, in view of continuing reduction in interest yields, our business requirements and as a matter of business prudence, keeping in mind the increased market perception about alleged payment problems in the stock exchanges and the increased volatility in the stock markets".

6.143 SEBI stated in a reply furnished to the Committee subsequently that it was contended by RSSBL that on 28.2.2001, when their funds deployed declined by Rs. 605 crore, their orders in the market worth Rs. 780 crore did not get executed till the end of the session and total investment offered on 28.2.2001 was in excess of Rs.1700 crore.

6.144 According to BSE, during the period from January to March 2001, all the market participants were gradually withdrawing the total Vyaj Badla finance. Vyaj Badla finance fell from Rs. 3145.35 crore on 17.2.2001 to Rs.1124.67 crore on 31.3.2001 as the outstanding purchase carry forward position in the market was also gradually reducing. The return on deployment of funds in the ALBM was stated to be generally in the range of around 15-21% per annum whereas the yields of other instruments in the short term markets was stated to be in the region of 7-8% per annum.

6.145 Pointing out that if a player could distort the market by pumping in or withdrawing funds from ALBM thereby raising or depressing the market, the Committee enquired whether such an action would not amount to manipulation of the market. In response, the Chairman SEBI said:—

“It is very difficult to say that at this stage. My submission is that if one is entitled to put in money, if one is a registered entity, one is entitled to withdraw the money if the activity is legal; unless there is some additional factor to prove that this was done with some kind of an intention.”

6.146 A representative of SEBI admitted during evidence that financing aspect of ALBM was left out in the risk management system and that this aspect was not looked into. The witness also mentioned in this context that one of the problems which had plagued the Indian markets was the non-availability of transparent regulated organised sources of funding through the banking system into the capital market and that it was to fill this void, the need for carry forward schemes and ALBM had arisen.

6.147 To a query as to why SEBI had not investigated ALBM soon after the crash of the market in March, 2001 but took up only on the instruction of the JPC, the Chairman, SEBI said that NSCCL “was the one body which we left out.”

6.148 SEBI’s instructions regarding Surveillance issues appear to be conflicting. While its instructions in August, 1995 stipulated that the Surveillance Department of the Stock Exchanges should be directly under the Executive Director with a view to insulating the surveillance system from broker office-bearers and broker Directors, its directive in August, 1996 required that Governing Boards of the Stock Exchanges should review the functioning of their Surveillance Department. This ambiguity in the SEBI’s instructions apparently has led BSE to include broker directors in the Surveillance Committee constituted in May, 2000. The Committee urge SEBI to look into these obvious contradictions in its circulars and issue suitable instructions clarifying the position.

6.149 The Surveillance Committee of BSE although constituted on 25.5.2000, did not hold any sitting for over 7 months. The Committee find that it was during this period that the market manipulations and irregularities were taking place. It is inexplicable why having constituted a Surveillance Committee, the BSE did not make it functional for a long time. Review of surveillance functions by an Exchange is an important area in the context of investors protection. The Committee feel that the institutional mechanism in the Stock Exchanges to undertake review of surveillance functions should be made purposeful and effective by holding periodical meetings and reviews. The Committee are also of the view that report on functioning of Surveillance Committee should be submitted by Stock Exchanges to SEBI every six months.

6.150 The Committee are of the view that obtaining trade related information from the Surveillance Department by a broker director holding official position in a Stock Exchange is in violation of norms. It is evident that the trade related information obtained from the Surveillance Department by the then President of the Stock Exchange, Mumbai (BSE) on 2.3.2001 was price sensitive. It is clear that he had in the past too sought to obtain similar information from the Surveillance Director. Such acts are in violation and have the effect of eroding the confidence of investors in the working of Securities Market. This episode underlines the urgent need for demutualisation of Stock Exchanges. The Committee note that as a first step in this direction, SEBI has recently issued a directive prohibiting broker-directors from holding the position of President, Vice-President or Treasurer of a Stock Exchange. The Committee urge that as discussed elsewhere in this report demutualisation exercise should be completed early.

6.151 The Executive Director of the Stock Exchange is vested with the responsibility for the proper and independent functioning of the Surveillance Department. It is shocking to note that the then Executive Director of BSE did not consider the instances of the then President's seeking information from the Surveillance Department objectionable. The Executive Director admitted that the information obtained from the Surveillance Department by the then President on 2.3.2001 was "sensitive". The fact that he had not thought it fit to place this fact before the governing body of the Exchange shows that either this was common practice or there was collusion between the then President and the Executive Director. All these cast doubt on the integrity and effectiveness of the Executive Director and call for strict action.

6.152 Shri A.A. Tirodkar, the then Director of Surveillance in BSE was the person responsible for bringing to light the sordid affairs concerning the then President of BSE. The Committee are distressed to note that Shri Tirodkar was asked to proceed on leave and was initially subjected to an in-house enquiry and later by an independent enquiry. The independent enquiry has although recently exonerated Shri Tirodkar, has given the option to BSE to terminate his services. It should be ensured that Shri Tirodkar is not victimized by the BSE. Whistleblowers should be given protection so that wrong doings in any institution can have an attitude without fear. The Committee found that a very timid and helpless attitude was prevalent at all the levels in stock exchanges.

6.153 That the governing body of BSE passed a resolution expressing complete confidence in the integrity of the then President even while his wrongful activities were brought to public knowledge is something disquieting. Such a resolution amounted to pre-empting an enquiry against the latter and handing him over a clean chit. It is a matter of concern that the SEBI Nominee Director too was a party to that resolution though he retracted his stand four months after passing that resolution. The role and functions of SEBI nominee Director in a Stock Exchange ought to be clearly laid down.

6.154 The Committee note that Automated Lending and Borrowing Mechanism (ALBM) of National Securities Clearing Corporation Limited (NSCCL) introduced in February, 1999 was modified within 10 months in December, 1999. The modified ALBM incorporated features of deferral product and it did not have risk containment measures which are normally required in this regard. The Committee expect NSE to exercise due care and caution and observe due process before introduction/modification of a scheme keeping in view the larger interests of investors.

6.155 SEBI's handling of the issue relating to the revised ALBM leaves much to be desired. Though NSE had filed revised scheme with SEBI in October, 1999 and operationalised it in December 1999, i.e. after two months, SEBI did not consider the proposal for revision even though the carry forward character of the revised scheme had become known to them in early January 2000 itself as is evident from the perusal of the file submitted by SEBI. They also did not think fit to stop the operation of the Modified Scheme even after realizing that the modification involved great risk to the investors. The apparent lack of risk management measures in the revised ALBM should have led SEBI to take immediate corrective measures. It took seven months for SEBI to decide that the issue needed to be examined by an expert group. The Group appointed for this purpose under the Chairmanship of Prof. J.R. Varma submitted its report in July, 2000 and on the basis of its recommendations SEBI prescribed some risk containment measures but adequate risk management measures were still not put in place till October 2000, when it finally accorded its approval to revised ALBM scheme. Even then the risk containment measures prescribed by SEBI were not complete. SEBI permitted withdrawal of securities from the clearing house under the ALBM despite the fact that the G.S. Patel Committee which went into the issue of reintroduction of "badla" had categorically recommended as early as in 1995 not to permit withdrawal of securities under the Modified Carry Forward Scheme. It was only in

February 2001, SEBI rescinded the provision for withdrawal of shares from the clearing house under the ALBM.

6.156 One of the terms of reference of the Varma Group was to determine whether the modified ALBM introduced by NSCCL was in conformity with the Stock Lending Scheme. The Group has not given its report on this aspect so far. The Committee are at a loss to understand the inordinate delay in this regard.

6.157 The Committee note that the amount of funds deployed by one player in ALBM, BLESS and Vyaj Badla financing was as much as Rs. 1900 crore towards the end of February, 2001. These funds were not deployed in the market between 28.2.2001 and 7.3.2001 and was reduced to Nil. It was initially stated that the non-deployment of funds by the player from the market was due to continuing reduction in interest yields, business requirements, increased volatility in the stock markets etc. Subsequently, it was contended that their orders in the market worth Rs. 780 crore did not get executed though their total investment offered in 28.2.2001 was in excess of Rs. 1700 crore. In Committees' view, whatever be the reason for non-deployment, such huge withdrawal of funds from the market could cause adverse impact in the market.

6.158 Though SEBI discontinued ALBM and other deferral products w.e.f. 2.7.2001, SEBI did not initiate any investigation of ALBM after the crash. It was only at the instance of JPC that SEBI took up investigation of ALBM and came out with a detailed report after persistent and probing questioning by the JPC. The Committee would expect SEBI to be more alert in the performance of its functions. They would also expect SEBI to provide more checks and balances and exercise better regulations for all financing schemes relating to the stock market in future.

## CHAPTER VII

### ROLE OF PROMOTERS AND CORPORATE ENTITIES

7.1 The unusual volatility in the stock market between 1.9.1999 and 30.3.2001 is attributed to various contributaries. Two such significant contributaries were promoters and corporate entities. Any in-depth study to analyse the genesis of the scam, also the subject-matter of the Committee's enquiry, would be incomplete without focusing on the role of promoters and corporate entities. Their role was considered to be relevant even during the enquiry into the 1992 stock market scam by the previous Joint Parliamentary Committee. This is illustrated by the following observations made in their Report that "the Committee had come across various instances of close nexus between prominent industrial houses, banks and brokers."

7.2 In the Action Taken Report of December, 1994, it was observed that CBDT had set up a Special Cell with nominees from CBI, RBI and the Department of Company Affairs to investigate into the involvement of big industrial houses in the scam. This cell was coordinated by the Director-General of Income-tax and Investigation at Bombay. The special has since finalised the report in September, 2002.

7.3 When the Committee enquired about the work of the Special Cell since December, 1994, the Committee realised that no progress worth its name had been made. The Special Cell was almost defunct as dealt with in paragraph 3.12, Chapter III. The Committee note with disappointment the laggard manner in which the recommendations of the previous Committee were treated. Not only this, the Committee consider such an approach as symptomatic of the non-serious attitude of various regulators who hesitate to take action when required, and do so only when prodded. Regulatory authorities must shed their lackadaisical and negative mindset, especially in the context of regulating the stock market, the rise and fall of which not only determines the fortunes of many but the health of which should symbolize the health of the state of the economy. One of the root causes of the scam is this mindset.

7.4 The failure in investigating into the role of promoters and corporate entities while share prices of particular scrips were being artificially manipulated has been attributed by SEBI to the absence of authority to investigate into their role under the Securities and Exchange Board of India Act, 1992. Under Section 11(2)(i), SEBI is charged with responsibility of calling for information, undertaking inspections, conducting enquiries and audit of the stock exchanges, mutual funds, other persons associated with the stock market, intermediaries and self-regulatory organisations in the stock market. Though it may be possible to contend that SEBI did not enjoy the authority to directly investigate corporate entities which might have, through various channels, provided funding in the stock market. That the promoters and corporate entities were, at the relevant time, playing a significant role cannot be denied. The Department of Company Affairs, one of the entities having regulatory authority could have, had it informed itself of this or been alerted to the role of promoters and corporate entities, taken timely action in the matter. Diversion of funds allocated to specific projects for use in the stock market for the purchase of specific scrips, investment companies operating in the stock market through brokers, nexus between brokers and corporate entities in the context of the interests of brokers in specific corporate

entities, which facts have now come to light, establish the nexus between brokers and corporate entities. The proximity of promoters and brokers is also established by the frequency with which both acted in collusion by the use of circular trading in respect of shares of certain companies, with the sole objective of creating an impression that the scrip in which circular trading is effected was heavily traded; consequently enticing innocent participants in the stock market to purchase the scrip of that company. These and other factors contributed largely to the artificial inflation of share prices in specific scrips, particularly known as the "K-10 stocks" which, in turn, contributed in large measure to a sentiment being created in the market which enthused others to invest solely in these specific scrips and the stock market in general.

7.5 Amendments made in the Companies Act removing restrictions on inter-corporate deposits contributed to the huge transfer of monies from companies to individual stock brokers resulting in volumes that had not before been seen in the stock market. It can be said that the primary regulator of the stock market is SEBI, with which rests the ultimate authority, and the various stock exchanges themselves. However, as far as the activities of corporate entities in using their funds for the manipulation of share prices is concerned, that function could only have been performed by the Department of Company Affairs. The Secretary, Department of Company Affairs, when asked about the machinery available with the Department for investigating the affairs of the companies, stated the following:—

"Sir, first of all, we have got about 21 or 22 inspectors in the whole country. Out of that, four people are there not for inspections but for what is called follow up. So, effectively, we have only about 18 inspectors in the whole country, which is not a huge number.....Secondly, it is our observation that while these inspectors try to do their best, they have got some in-built limitations. Looking into the finances, the balance sheets, the nuances of the accounts is a highly technical kind of job."

7.6 This statement of the Secretary, Department of Company Affairs, demonstrates, since the Department of Company Affairs is a regulator, that it could have been alive to the requirement of investigating the role of promoters and corporate entities, the nexus between corporate entities and promoters in contributing to the artificial volatility created between 1.9.1999 and 30.3.2001. It could not have played a significant role in that regard in the absence of an appropriate administrative machinery to investigate into these matters. SEBI and the various exchanges did not consider it within the ambit of their powers to undertake such an enquiry and the Department of Company Affairs was neither alive to their role nor did it have the administrative machinery to investigate it. For this reason, when the present Committee undertook its task and raised the issue of the role of promoters and corporate entities, a feeble attempt was made by SEBI to investigate into the role of certain promoters and corporate entities. Despite the three interim reports submitted by SEBI, and in the absence of a final report, the Committee did not have sufficient material to probe further into the matter. Despite reminders to SEBI to submit its final report, SEBI has chosen thus far not to do so. The Committee, on their own, because of the enormity of its task, found that the completion of its work would be further delayed if, with the limited material in its possession, it sought to summon those in management of certain promoter-groups and corporate entities, and tried seeking an explanation from them before arriving at its findings. Such an attempt, even if made, would have been half-baked, since the necessary data which would have helped the Committee in its task was not available in their entirety.

#### **A. ASSESSMENT OF 200 SCRIPS**

7.7 Two lists of scrips were compiled - one list containing names of 727 scrips which had unusual increase in share prices between 1.9.1999 and 31.3.2000 and another list containing

names of 199 scrips which experienced unusual fall in share prices between 1.2.2000 and 30.3.2001. The Committee forwarded these two lists to SEBI and desired SEBI's assessment in regard 100 scrips which had witnessed unusual rise in prices and 100 scrips which had witnessed unusual fall in prices as to whether in both up and down movement of the prices there had been irregularities and manipulations.

7.8 SEBI accordingly selected 100 scrips each from the two lists and furnished reports giving its assessment. An analysis of SEBI's assessment of these scrips showed that there was likelihood of manipulations or irregularities in 55 out of 100 scrips which experienced unusual rise in prices. Evidence of manipulations/irregularities was noticed in 26 out of 100 scrips which experienced unusual fall in prices. There were 12 scrips against which there was prima-facie evidence of manipulations/irregularities both during rise in prices as well as during fall in prices.

7.9 SEBI has stated that in the case of 146 out of the 200 scrips investigation/examination had been undertaken by Stock Exchange or by SEBI. SEBI further stated (in October 2001) that in respect of the 727 scrips listed by the Committee as having witnessed unusual rise in prices, the stock exchanges had taken a number of measures in the last two years. In the case of 395 scrips, at least one action of the type of imposition of special margin, imposition of additional volatility margin, reduction of circuit filter or investigation etc. had been taken. Of the remaining 332 scrips, only 16 scrips got traded above Rs.20. In respect of scrips traded below Rs. 20, SEBI had not fixed any price bands and these matters were left to the Exchanges.

## **B. INVESTIGATION BY SEBI**

7.10 SEBI's investigations undertaken in the context of CSE payment problem and crash of MNCB in March 2001 covered a number of scrips. SEBI submitted four interim reports which, inter-alia, covered trading pattern about these scrips. Irregularities as brought out by SEBI, Enforcement Directorate, Department of Company Affairs and CBI are mentioned below:—

### **1. Adani Exports Ltd.**

7.11 The price of the scrip moved up from Rs. 621 as on 10.11.1999 to hit a 52 week high of Rs.1,271/- on 10.12.1999 in NSE. The promoters/associate companies of Adani Exports had sold shares to Ketan Parekh entities through cross deals. NSE found 36 such cross deals during the period 17.11.1999 to 14.12.1999. In November 1999, the entities associated with the Adani Exports sold a total of 5 lakhs shares which were bought by Ketan group entities. Similar type of deals were found subsequently also. Buying and selling pattern by Ketan Parekh entities suggested that artificial trading volumes were created in the scrip.

7.12 According to SEBI, there appears to be close relationship between Adani Group and KP Group of entities based on the following facts :—

- (a) There were fund flows involving crores of rupees between these entities for which no interest was charged. Investigations revealed that Adani group has given around Rs.340 crores to Ketan Parekh entities and has received around Rs.208 crores from them.
- (b) The promoters of Adani Exports sold shares through KP group broking entity and all shares were bought by other KP group entities as investors, and
- (c) Ketan Parekh was the major shareholder in one of the group entities of Adani Group, Adani Ports Ltd. with a shareholding of 32 lakh shares as on 29.12.2000.

## 2. Aftek Infosys Ltd.

7.13 Prior to IPO in 1995, the share capital of the company was 5.00 lakhs shares. In April 1995, the company offered 37.40 lakh shares as IPO. In January 1999, the company offered 15.00 lakh shares on a preferential basis at premium of Rs.26.50 per share and this brought the total issued capital to 57.40 lakh shares. In February 2000, the company made a further preferential offer of 2.60 lakh shares at a price of Rs.3,674/- per share, which moved the issued capital of the company to 60.00 lakh shares and the aggregate face value of equity capital of the company was Rs.6.00 crores.

7.14 At the time of IPO in 1995, the company allotted 10.00 lakh shares to IDBI, as a venture capital undertaking, and in the subscription agreement, the promoters had agreed to buy back these shares as and when called by IDBI at market related prices.

7.15 The price of the scrip witnessed marked increase during the period April 1999 to March 2000 on the BSE. The price of the share increased from Rs. 477 on 12.11.1999 to Rs. 1108 on 3.12.1999. The share price continued to spurt and touched a high of Rs. 5000 in March 2000. The role of promoters in this regard as brought out by SEBI is summarized below :—

- (i) Ketan Parekh entities acquired 7.3 lakh Aftek shares (12.7%) in the preferential allotment made by the company in January 1999. Ketan Parekh Group also purchased 5 lakh shares (7.88%) from other preferential allottees—Sungarce and Vinsan—companies connected with promoters of HFCL.
- (ii) On 12.11.99, IDBI offered to sell to the promoters 9 lakh shares at prevailing market price of Rs. 477.75 and called upon the promoters to pay 10% of the amount by 15.11.99 and remaining 90% by 19.11.99. Promoters of the company approached Ketan Parekh for obtaining finance to acquire the shares from IDBI who had provided finance in the name of 4 of his entities. Promoters through structured arrangement with Ketan Parekh enabled him in acquiring large number of shares at a price at which they acquired from IDBI. Ketan Parekh acquired large quantity of shares at a price of Rs. 477.75/- when market price was at Rs.1292.5/-. Thus, shares worth Rs.103.40 crore were acquired by Ketan Parekh from the promoters at Rs. 35.82 crore. The promoters thus colluded with Ketan Parekh entities to make available substantial holding in the scrip at a very low price.

The promoter facilitated cornering of shares in the hands of Ketan Parekh entities through preferential allotment, and structured financing cum option agreements. The cornering of shares by the Ketan Parekh entities facilitated price manipulation by these entities who indulged in large buy and sell orders, circular trades, artificially increasing the price by putting successive buy orders at a price higher than last traded price especially in particular time slots and abuse of circuit filter mechanism. Through roping in of FIs, mutual funds etc. and managing good press, Ketan Parekh entities were able to generate enormous interest in the scrip. The manipulative trading coupled with fancy for technology stock led to price escalation upto Rs.5000/-

7.16 Prima facie the following violations have been observed by SEBI:—

- (a) Acquisition of shares by entities belonging to the Ketan Parekh group, in excess of 15%, acquisition of shares by the promoters of the company in excess of 5%, and acquisition of shares in excess of 5% by Vidyut Investments Ltd. without following the requirements of making disclosures and making a public offer to the remaining shareholders under the SEBI (Substantial acquisition of shares and Takeovers) Regulations, 1997.
- (b) Price manipulation by the Ketan Parekh group.

7.17 SEBI has informed that the following action has been taken:—

- (i) Penalty of Rs. 5,50,000 has been levied collectively on all the promoters of the company for acquisition of 9 lakh shares (15.87% of the paid up capital) without making a public offer. The penalty has been paid.
- (ii) Adjudication and Quasi Judicial proceedings are in progress for violation of regulations regarding Substantial Acquisition of shares and fraudulent trade practices against Ketan Parekh entities and other entities involved.
- (iii) Enquiry proceedings are in progress against brokers—Triumph Securities Ltd., Latin Manharlal and Milan Mahendra.

SEBI has informed that the case may be examined from prosecution angle also.

### 3. CYBERSPACE INFOSYS LIMITED

7.18 The Committee examined Shri A.M. Johari and Shri A.K. Johari, Shri Gorakh N. Srivastava. The Committee had the benefit of finding of SEBI, investigation by CBI, DCA as well as personal evidence.

#### A. SEBI findings :—

- (i) Shri A.M. Johari and Shri A.K. Johari, the promoter directors of Cyberspace Limited and Century Consultants Ltd. opened shell companies in the names of employees of their firms and had financed these companies to trade in the scrip of Cyberspace in order to create artificial volume and manipulate the price of the scrip. The whole operation was carried out by the promoters while the employees were kept in dark.
- (ii) The promoters also induced some of its investors to trade in the shares of Cyberspace Infosys Limited. Further, they also carried out transactions on their behalf and financed these trades.
- (iii) The employees of Century Consultants allured investors to invest in the shares of Cyberspace Infosys Limited promising high return. They used to advice clients about the quantity to be sold and the time at which they should be sold.
- (iv) Century Consultants Limited, Cyberspace Infosys Limited and the entities closely connected with them have traded significantly in a circular manner in the scrip of Cyberspace Infosys Limited.
- (v) It appears that the intention of the Century Consultants and its associate entities was to create a false & misleading appearance of activity in the scrip and a false market momentum in order to evoke interest in the scrip from investors and profit from the same.
- (vi) It is apparent that the following parties are related to each other or are working in conjunction with the promoters of Cyberspace Infosys Limited:
  - (a) *Ramesh Shah*
  - (b) *Country Informtech Services Pvt. Ltd.*
  - (c) *Shivam Multi Services P. Ltd.*
  - (d) *Rosewood Tradelinks P. Ltd.*

- (e) *Arvind Johri*
- (f) *S.G. Gadani*
- (g) *Jugal Kishore Barasia*
- (h) *Pradeepak Finance & Mgmt. Consultants P. Ltd.*
- (i) *Delta Investments*
- (j) *Badani*
- (k) *Arihant Investments*
- (l) *Amit Interchemicals P. Ltd.*
- (m) *Octopus Soft-Tel P. Ltd.*
- (n) *A M Johri & Co.*
- (o) *Century Consultants*

Prima facie it appears that the promoters of Cyberspace Infosys Limited and Centrury Consultants Limited were providing necessary funds to the above parties in order to settle the transactions in the scrip of Cyberspace Infosys Limited.

7.19 SEBI has since directed Shri Arvind Johari, Century Consultants Ltd. (Member of BSE and NSE), Shri A.K. Johari (Member, Uttar Pradesh Stock Exchange) and Shri A.M. Johari (Member, Delhi Stock Exchange) not to undertake any fresh business as brokers till further orders. Action has also been proposed against some of the investors who appear to be associated with the promoters of Cyberspace Infosys Ltd. SEBI has ordered enquiry against 14 brokers of BSE and 18 brokers of NSE.

## **B. Investigations by CBI**

7.20 CBI's investigations have revealed that Cyberspace Infosys Ltd., through its directors mainly Arvind M. Johri entered into a criminal conspiracy with UTI officials that resulted in subscription of 3.45 lakh shares of M/s. Cyberspace Infosys Ltd. at an exorbitant rate of Rs. 930 per share on private placement basis in 27.7.2002 against advice of Equity Research Cell of UTI as well as of all the concerned Fund Managers of UTI. The entire amount of approx. Rs. 32.09 crore released by UTI was not utilized for business as was stipulated in the offer document by Cyberspace Infosys Ltd., but the same was diverted to Stock Exchange through a circuitous route, involving large number of Banks and Bank accounts, to meet the obligations of Group Companies of Cyberspace Infosys Ltd., as well as for purchase of shares of Cyberspace Infosys Ltd., by different entities of the Johri Group i.e. Promoters of Cyberspace Infosys Ltd., to maintain the share price of Cyberspace Infosys Ltd., at higher level with a view to dispose the shares in future at a profit thus, subjecting the investors to loss.

7.21 CBI has stated that a case has been registered against Cyberspace Infosys Ltd., Arvind M. Johri, Director of Cyberspace, P.S. Subramanyam, Ex-Chairman, UTI, Late M.M. Kapur, the then Executive Director, UTI, S.K. Basu, Executive Director, UTI, Smt. Prema Madhu Prasad, GM, UTI for having entered into criminal conspiracy amongst themselves and with other unknown persons with the object to cause wrongful loss to Unit Trust of India and extend illegal benefit to Cyberspace Infosys Ltd., and its Directors in the matter of private placement of shares of Cyberspace Infosys Ltd. Later Shri Rakesh Mehta, a share broker was also added as accused during investigation.

### C. Investigations by DCA

7.22 Investigation by the Department of Company Affairs has revealed that the Cyberspace Ltd. had violated Section 62/63 and 209 of the Companies Act by mistatement in prospectus and non-production of accounts and other records.

## 4. DSQ SOFTWARE

### A. SEBI findings

7.23 There was an abnormal spurt in prices and volume of DSQ Software. The price of the scrip rose from Rs. 250 to Rs. 2631 during October 1999 to March 2000 and fell to Rs. 150 in mid-March 2001. SEBI's findings regarding involvement of promoters/associated entities of the company are as follows:—

- (i) Unauthorized allotment of one crore shares was made by the company in October/December 2000 out of which 60 lakh shares were allotted to Dinesh Dalmia Technology Trust and 40 lakh shares to Dr. Suryanil Ghosh Trustee Softee Corporation. These shares were allotted without any resolution passed by the company and without receipt of any funds and also without following any procedure under the Company Law. These shares were finally transferred to entities connected with promoters and were sold/given to various brokers. The entities connected with promoters were indulging in circular trades and fictitious trades with a view to create an artificial market in the scrip.
- (ii) 30 lakh shares with distinctive no. 30250001 to 33250000 were allotted on preferential basis to New Vision Investment Ltd., UK, on May 20, 2000 at a premium of Rs. 970/- per share on a partly paid up basis. The shares were later forfeited by the company on account of non-payment of call money. The entire lot of 30 lakh shares had earlier been sold by New Vision Investment Ltd. in the market or transferred to DSQ Holdings and Mehta & Ajmera.
- (iii) Entities appeared to be connected with promoters viz. DSQ Holdings Ltd., DSQ Industries, Hulda Trades and Properties Ltd. have dealt heavily in the shares of the company. These entities have sold shares through brokers—Dresdner Kleinwort Benson (DKB) and Prabhudas Lilladher. Nearly one crore shares (30% of the total paid up capital) was sold through DKB alone. Some of these entities have transacted through three Calcutta based defaulting broker groups—Biyani, Poddar and Singhania.
- (iv) Hulda and DSQ Holdings indulged in circular trading to create artificial volumes in the scrip. These entities bought shares through one set of brokers and simultaneously sold shares through another set of brokers.
- (v) Promoter broker nexus is further proved beyond doubt when it was seen that the counter party buying brokers to sale by promoter entities through DKB and Prabhudas were Accord Capital, SMIFS Sec., C Mackertich Ltd., Mehta & Ajmera, Suresh Jajoo group (Millenium, Omega, Woodstock Sec. Woodstock Broking), Biyani Securities, Khandwala Finance. DSQ Software gave Rs. 25 crore to Accord, Rs. 54 crore to Mehta & Ajmera, Rs. 20 crore to Woodstock and Rs. 5 crore to Titan totaling Rs. 104 crore. DSQ also gave funds to associated entities—Time (Rs. 50 cr.) and Annapurna (Rs. 54 cr.) totaling Rs. 104 cr. These funds appear to have been primarily used to buy shares to DSQ Software i.e. in violation of section 77 of the Companies Act.

- (vi) Promoter related entities have given large number of shares of DSQ Industries and DSQ Software to Ketan Parekh entities. These shares were in turn either sold or pledged by the Ketan Parekh entities to come out of the payment difficulties arising out of highly leveraged position. DSQ Software gave funds to Ketan Parekh entities to the tune of Rs. 75 cr. Further, on 30.12.99, when the company made a preferential allotment of 1 crore shares of DSQ Software @ Rs. 275/- per share to FII's, OCB's etc. Ketan Parekh entities—Classic Credit Ltd. and Saimangal Investrade Ltd. were allotted 9 lakh shares each. The preferential allotment was made at a discount of almost 67% to prevailing market price of the share. Classic Credit Ltd. sold all the 9 lakh shares allotted to it within 4 months of allotment. The net benefit accrued to Classic Credit Ltd. as a result of sales of 9 lakh shares is approximately to the tune of Rs. 144.5 cr. Out of 9 lakh shares allotted to Saimangal Investrade 5,45,000 shares were bought back by DSQ Holdings which is a promoter group company in off-market transactions. Further 42,50,000 shares of DSQ Biotech were given by DSQ group/associated entities to Ketan Parekh. The market value of these shares is approximately Rs. 74.35 cr. Thus, funds to the tune of approximately Rs. 75 cr. And shares worth Rs. 400 crores (totaling to Rs. 475 crores approximately) have been given by DSQ group to Ketan Parekh entities.
- (vii) An OCB-Greenfield Investments Ltd. was holding 96 lakh shares (47.87% of the total paid-up capital of the company) of DSQ Industries as per distribution schedule as on 28.9.2000. It sold 54 lakh shares of DSQ Industries Ltd. in the CSE through the brokers—Mehta & Ajmera and Harish Chandra Biyani. This sale transactions constituted almost 25% of the total paid-up capital of DSQ Industries Ltd.
- (viii) The transactions with Biyani Securities also indicate nexus between DSQ Software and the broker. Biyani Group had large positions in the scrip of DSQ. The gross volumes of this group during October 1999 to March 2000 were around 66 lakh shares out of total volume of 11.28 crore shares. 90% of the trading was proprietary trading. In the subsequent period (April 2000 to March 2001), the volumes of Biyani Group were 5.57 crore shares (buy)/5.53 crore shares (sell) out of the total volumes at the exchange of around 58 crore shares.
- (ix) Acquisition of Fortuna Technologies, a US based Company by DSQ Software against swap of 14 million DSQ shares in physical form to three Mauritius based OCBs, *prima facie* was not found to be genuine and correct. SEBI, therefore, issued directions asking DSQ to cancel this alleged acquisition of Fortuna Technologies and prohibited DSQ from accessing capital market and debarred Mr. Dinesh Dalmia, Managing Director, DSQ from dealing in securities for a period of one year or completion of investigation and action thereupon whichever is later.

7.24 SEBI further mentioned that the investigation was done mainly on the basis of the information submitted by these entities in soft form in floppies and CDs and the data collected from these entities (Biyani Group) was voluminous (approx. 12 lakh records). The books of accounts and records were not made available for the purpose of investigation and therefore the background of the clients, Contract Notes, original documents, supporting entries made in the books of accounts, bills, copies of receipts issued for payments received from the clients, original Sauda Book, etc., could not be examined. In the absence of further details regarding these entities, such as the client introduction forms and other records relating to the clients, analysis on the background of each of these entities could not be performed and also the genuineness of the dealings done on behalf of these clients also could not be verified.

7.25 SEBI has stated that in order to draw out further evidence required to establish allegations of market manipulations, insider trading etc. further investigations into fund flow, source of shares are already underway.

7.26 SEBI also furnished an investigation report in October 2002 regarding DSQ Biotech Ltd. on a case pertaining to insider trading occurred in 1995. This case apparently has nothing to do with the present scam.

## **B. Investigation by Enforcement Directorate**

- 7.27 (i) According to the Enforcement Directorate, the allotment of 30 lakh shares in May 2000 to New Vision Investments Ltd., U.K. by DSQ Software Ltd. was apparently in violation of the provisions of FERA, 1973. The in-principle approval given by RBI on 20.05.2000 for allotment of 30 lakh shares to Foreign Institutional Investors (FIIs) had conditions that the FIIs should not only be registered with SEBI but also have RBI permission under FERA for making investment in the Indian capital market. New Vision Investment Ltd. do not appear to be either FII or have any RBI permission under section 29 of FERA. DSQ Software Ltd. and four Directors, including Sh. Dinesh Dalmia, have therefore been charged with the contravention of provisions of section 19(1)(d) and 19(4) r/w section 64(2) of FERA, 1973 in the matter of issue of 30 lakh equity shares for a total share price of Rs.294 crore to New Vision Investment Ltd., U.K. on preferential basis on or around 20.05.2000. A requisite complaint in this regard was filed against DSQ Software Ltd. and the four Directors in the CMM Court, Mumbai on 30.5.2002.
- (ii) In regard to acquisition of Fortuna Technology Inc. USA (a company belonging to Shri T.C. Ashok of USA) by DSQ Software, the ED has stated that as per the version of Shri Dinesh Dalmia these shares were to be allotted to three Mauritius based OCB's which were reportedly, controlling the entire stake of Fortuna Technology Inc., USA, as per the advice of Shri T.C. Ashok. However, later on as advised by Shri T.C. Ashok, three companies of nearly matching names of those of the alleged OCBs were incorporated in India and the said 1.4 crores shares were allotted in their favour. The said swap deal was however, cancelled by the SEBI during their investigation into the scam. ED has further stated that Shri P.V. Raju of Hyderabad, who was one of the signing witness to the agreement entered into between DSQ and T.C. Ashok in June 2001 regarding Fortuna Technology Deal has stated that it was not a swap deal and that it was a cash deal with the consideration of U.S.\$25mn.(approx.) for which a formal agreement was signed at USA. Further investigations are stated to be in progress.

## **C. Investigation by DCA**

7.28 The investigation by the Department of Company Affairs has shown that the Company made loans of Rs. 143.97 crore without interest and Rs. 129 crore at interest lower than bank rate during the year 2000 in violation of Section 372A(3) of Companies Act. Loans were given to Companies/firms in which the directors were interested, in violation of Section 295 of Companies Act.

## **5. Global Telesystems Ltd. (GTL)**

7.29 The scrip of the Global Tele-systems witnessed wide fluctuations in price from Oct. 1999 to March 2001. The price of the scrip moved up from Rs.508 to Rs.3310 in six months from 1.10.1999 to 31.3.2000. By end of May 2000, it fell to Rs.875 and by end of March 2001 it further fell to Rs.162. SEBI's investigations of the scrip have brought out the following:—

- (i) The share capital of the company has increased from approx. 2.61 crore shares in September 1998 to over 7.02 crore shares in 2001-2002. An unlisted company viz. Global Electronic Commerce Services Ltd. (GECS) promoted by the Global Group

and the Chanrai family was merged with GTL on 1.4.2000. The merger ratio of GECS with GTL was 6:1. The share holding of promoter and associates of promoter in GTL has gone up from approx. 81.79 lakh shares representing 18.82% of the total No. of shares as on 7.7.2000 to 1.71 crore shares representing 24.32% of the increased share capital as on 30.7.2001.

- (ii) From April 1998 to March, 2000, the company had allotted about 1.86 crore shares under FCCB conversion out of which around 92% of the shares were allotted to nine entities. Two OCBs viz. Bolton Finance Ltd. which was allotted over 24 lakh shares (12.91% of total shares allotted), and Invcom Investments Limited which was allotted 19.59 lakh shares (10.53% of total shares allotted) made large off-market transfer of most of the shares received upon the FCCB conversion to various entities including Brentfield Holding Ltd. (an OCB).
- (iii) Ketan Parekh entities had substantial trading in the scrip of GTL in BSE and NSE during the period from October 1999 to March 2001. The concentrated positions built by Ketan Parekh entities facilitated artificial taking up of the prices. Broking entities of Poddar Group, Singhania Group and Khemani Group had significant purchase position at Calcutta Stock Exchange. Large funds were transferred by Ketan Parekh entities to these brokers which were used for building up concentrated positions which enabled the brokers to manipulate the prices.
- (iv) The transactions of Ketan Parekh entities in the scrip of GTL through CSFB Securities and DKB Securities were financing transactions but given the colour of purchase and sale of shares. These financing, circular and fictitious trades were undertaken with a view to create artificial volumes and artificial markets in GTL.

## 6. Global Trust Bank

7.30 Findings/conclusions of the investigations conducted by SEBI regarding the scrip of GTB are summarised below:—

- (i) GTB shares are listed in Ahmedabad, Bangalore, Coimbatore, Hyderabad and Madras Stock exchanges, in addition to BSE and NSE.
- (ii) As per distribution schedule of 29.5.2000, the foreign holding was 21.50%, Indian Institutional holding 1.98%, body corporate 30.04%, directors and their relatives, 11.48%, public 34.99%.
- (iii) The Promoter entities of Global Trust Bank acquired 1.44 crore shares @ Rs.26.60/ @ Rs. 32.00 from their foreign collaborators—T A Enterprise Behad, Malaysia and Hambrecht & Quist Inc., USA. During September to December 1999, 1.31 crore shares (out of 1.44 crore) sold by promoter group and from others were purchased by Ketan Parekh entities through matched/washed/structured/synchronized deals and were placed with an FII client and made a profit of Rs. 2.46 crore. The prices of the scrip moved sharply during November 1999 to January 2000. However the promoters did not benefit from price rise as the promoters sold shares early on. ADB sold its entire holdings of 1 crore shares on April 11, 2000 at Rs. 83/- per share which were purchased by KP entities or associates through synchronised trades. IFC Washington sold 13.90 lakh shares between December 15, 2000 to March 31, 2001. GTB came out with a preferential allotment in March 2000. In all, 14.8 million shares were issued. Out of this, 1.3 million shares were allotted on preferential basis to some of the entities connected with Ketan Parekh—Chitrakut Computers Pvt. Ltd. and Nakshatra Software Pvt. Ltd.

- (iv) SEBI has stated that it received a reference in November 2000 from RBI saying that the price of the scrip of GTB has risen from Rs. 68.70 on 13.10.2000 to Rs. 92.65 on 10.11.2000 (on BSE) showing an increasing of 34.86% during the course of less than a month. During this period at least 12 other banks had shown a rise of more than 46% in their share prices. It further stated that during the same period, Bank index and BSE sensex showed an increase of just 4.78% and 5.40% respectively. It was also stated that there was information during the middle of October 2000 about a market player holding over 5% stake in the bank. RBI requested SEBI to make an enquiry into the market and advise them of any adverse features in this regard.
- (v) Data from exchanges for the period 9.10.2000 to 22.11.2000, has shown concentration in both purchases and sales. On BSE, three members accounted for 77% of gross purchases and two members accounted for 79% of gross sales. Two members accounted for 73% of net purchases and one member accounted 77% of net sales. Similar concentration was also seen on NSE. It is therefore apparent that trading during the period was concentrated among a few brokers only which had common clients in the form of Ketan Parekh entities.
- (vi) Ketan Parekh entities, Panther Fincap and Classic Credit resorted to circular trading and transfer of shares. Panther Fincap has dealt with each of the top 10 trading members and Classic Credit transferred large volume of shares (more than 5.00 lakhs).
- (vii) Based on the information, SEBI is of the view that Vidyut Investments, a group company of Ranbaxy, and certain OCBs, European Investments Ltd., Far East Investments Ltd., Brentfield Holdings Ltd., Wakefield Holdings Ltd., and Kensington Investments Ltd., and FIs sub-account Kallar Kahar were used by Ketan Parekh Group as fronts for the purpose of parking large quantities of shares and also for purposes of circular trading and generating volumes. Credit Suisse First Boston has done circular trades on behalf of Ketan Parekh entities and their front entities. Investigations also revealed that Classic Credit, Panther Fincap and Vidyut Investments have separately violated SEBI takeover code by acquiring more than 5% shareholding of GTB at a given point in time and they did not disclose the same to the target company.
- (viii) GTB has provided fund and non-fund facilities to Ketan Parekh entities. GTB has acted as sole clearing banker for broking entities of Ketan Parekh Group and as per requirements of both BSE and NSE all purchases and sales of shares, transacted through the stock exchange are settled through their accounts with their sole clearing banker. GTB received obligation statements from both BSE and NSE providing various details and bank has stated that they, on the basis of these obligations statement, are able to monitor usage of funds. Further the Bank has submitted an audit report on utilization of bank funds by Ketan Parekh entities between October 2000 and February 2001 and is satisfied on end use of funds, as also that the loans are not used to trade in GTB shares. RBI has confirmed the same.
- (ix) Merger of GTB and UTI Bank: The valuation report from SBI Caps was called for. It was seen that share price is one of the parameters. Based on four parameters and qualitative factors, SBI Caps has suggested a swap ratio of 2.25 shares of UTI Bank for one share of GTB. Second valuation by Deloitte Haskins & Sells (DHS) also proposed a similar ratio after ignoring the periods of high prices of GTB. However, GTB called off the merger in April 2001.
- (x) On the question of insider trading by the promoters, SEBI has stated that "no evidence has been observed so far, which would bring the sale transactions of the promoters within the ambit of insider trading regulations."

- (xi) SEBI has also investigated price movements and transactions during the April to August 2000. On 11.4.2000, ADB sold its entire holding of 1.00 crore shares of GTB at a price of Rs.83/- on BSE and NSE through ICICI Brokerage Services Ltd. SEBI has since confirmed that 85 lakh shares sold by ADB were purchased by few broking entities associated and connected with Ketan Parekh. It appears that some entities associated with promoters of Shonkh Technology/Padmini Technologies and HFCL which are stated to be close to Ketan Parekh entities first purchased the shares sold by ADB through synchronized/matched deals and then sold these very shares to Ketan Parekh entities at a loss. The exact motive of such a transaction is being examined. SEBI is further investigating the matter.
- (xii) Based on all the above, SEBI has concluded that Ketan Parekh Group was also involved in number of structured transactions, synchronized transactions and cross deals. Classic Credit and Panther Fincap dealt with a view to manipulate the price of the scrip in October-November 2000 and violating SEBI provisions. Classic Credit, Panther Fincap and Vidyut Investments did not inform GTB of their acquisition of shares in excess of 5% and have violated regulation 7(2) of SEBI (Substantial acquisition of shares and takeover) Regulations.
- (xiii) NH Securities and Triumph Securities, Triumph International, CSFB, Hem Securities, CJ Dalal, Latin Manoharlal Securities, Milan Mahindra Securities, and Millennium Equities, facilitated price manipulation and distorted price discovery by abetting Ketan Parekh entities, which is violation of Regulation 4 of SEBI (prohibition of fraudulent and unfair practices) Regulation. Enquiries have been initiated on the above members.
- (xiv) Earlier, directions under Sec.11(b) of SEBI Act were issued for *prima facie* involvement of Ketan Parekh Group in price manipulation, prohibiting Ketan Parekh and entities connected with him to undertake fresh business as brokers.
- (xv) Vidyut investments has violated provisions of SEBI stock lending scheme and show cause notice has been issued.

7.31 SEBI submitted three investigation reports on GTB and concluded (a) there is no evidence of insider trading by promoters; (b) Promoters sold their shares in October—December 1999 before the share prices really went up high and have not benefited from the price rise; (c) Promoters sold only 90,000 shares during twelve months period April—March 2001 while ADB had sold its entire holdings of one crore shares at near peak price on a single day i.e., on April 11, 2000; and (d) IFC Washington sold 13.9 lakh shares during December 15, 2000 to March 31, 2001 also at near peak prices.

7.32 The Committee note that Ketan Parekh entities have purchased 1.31 crore shares sold by promoter group of GTB during September—December 1999 and sold to an FII for profit and 85 lakh shares sold by ADB in April 2000. SEBI is to be requested to investigate into the sale of 85 lakh shares by ADB on a single day at peak prices and sale of 13.9 lakh shares by IFC Washington in the first quarter of 2001 when the prices were ruling very high.

7.33 SEBI has informed that for violating the provisions of SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 1997 Panther Fincap & Management Services Limited and Classic Credit have been penalized to the extent of Rs.1.50 lakh each. Vidyut Investment has been directed to pay a penalty of Rs.1 lakh. European Investment Limited and Far East Investment Limited have been directed to pay a penalty of Rs.1.50 lakh for acting in concert while acquiring the shares.

## 7. Himachal Futuristic Communications Ltd. (HFCL)

7.34 The scrip of HFCL witnessed wide fluctuations in price from October 1999 to March 2001. The summary of SEBI's findings are as follows :—

- (i) During the period from January 2000 to March 2001, the promoter group companies of HFCL had transferred shares of HFCL to entities connected with Ketan Parekh and entered into Memorandum of Understanding with Ketan Parekh entities to sell these shares to a strategic investor, on their behalf, as a bulk deal. It was also agreed that the promoter group and associates would get maximum price of their shares which shall not be less than Rs. 1650/- per share. Investigations revealed that most of these shares were either sold in the market or pledged/given to other entities by Ketan Parekh entities. It has been stated that Ketan Parekh entities neither returned the shares so far nor have paid the proceeds of sale made by them unauthorisedly. The promoter group companies of HFCL has reportedly initiated legal proceedings and filed suit for recovery of shares/money from Ketan Parekh entities.
- (ii) Investigations *prima facie* revealed that, large amount of funds to the extent of approx. Rs.550 crore has been given by HFCL group to entities connected with Ketan Parekh Group. This fund was mainly given during January to March 2001 when the prices were coming down from its peak valuation. According to SEBI, there are no indications that promoters were involved in manipulations/jacking up of prices. It has been claimed that funds were given for investment in certain entertainment and telecommunication scrips etc. There were agreements with Ketan Parekh entities in support of this which were verified. It was also stated that since Ketan Parekh entities could not give some of these shares which were contracted for, appropriate legal proceedings have been initiated.
- (iii) It was observed from the NSDL statements that the promoters and associates had created/pledged some of their holdings. The details of total number of pledged shares, pledge, purpose of pledge, details of utilization of the benefits of pledge etc. in case of linkage with the brokers/dealings in the scrip are being collected and verified.
- (iv) Ketan Parekh entities cornered substantial quantity of stock of HFCL, which led to artificially raising of the prices. It was also seen that artificial volumes were created through purchase and sale across large number of brokers at various exchanges. Creation of artificial market through purchase and sale of shares simultaneously across various counters alongwith cornering of shares resulted in price manipulation in the scrip of HFCL by Ketan Parekh entities. SEBI is of the view the shares purchased by FIs were mainly delivered by Ketan Parekh entities which were earlier cornered.
- (v) Broking entities of Sanjay Khemani Group, Dinesh Kumar Singhania Group and Ashok Kumar Poddar had significant purchases in the settlements during the period from October 1999 to March 2001.
- (vi) Investigations also revealed that transactions of Ketan Parekh entities in scrips of HFCL through CSFB Securities and DKB Securities were financing transactions but given the colour of purchase and sale of shares.

## 8. Lupin Laboratories

7.35 The price of the scrip witnessed a sharp rise in price and increase in volumes during September 1999 to December 1999. The price of the scrip which was in the range of Rs.100-150

during April—August 1999 increased to Rs.600 during August—December, 1999. The price subsequently went down to Rs.150 in June 2000. SEBI's investigation arrived at the following conclusions:—

- (i) The entities associated/connected with Ketan Parekh acquired around 8.5 lakh shares of the scrip in August 1999 from the promoter group of Lupin Laboratories Ltd. in an off-market deal in violation of the Securities Contract (Regulation) Act.
- (ii) The entities associated/connected with Ketan Parekh created an artificial market for the scrip and manipulated its price during September—December 1999.
- (iii) Entities connected with Ketan Parekh and promoters consequently sold shares of the scrip in large quantities at the artificially high prices. It is observed that during November-December 1999, promoters reduced their share holdings of the scrip by about 48 lakh shares most of which were sold to various Foreign Institutional Investors (FIIs) at this artificially high price.

7.36 SEBI has stated in a written reply that quasi judicial proceedings are in progress against Ketan Parekh entities for *prima facie* violation of SEBI Regulations.

## 9. Padmini Technologies

7.37 SEBI's enquiries conducted so far, *prima facie*, show that the scrip price of Padmini witnessed an unusual price movement during three distinct periods, i.e., November 1999 to May 2000; 5.6.2000 to 7.7.2000 and 8.8.2000 to 31.8.2000. SEBI's findings are as follows :—

- (i) The preferential allotment of shares and the placement of 20 lakh shares to UTI by the company does not appear to be in accordance with law.
- (ii) Padmini facilitated the price movement by delaying transfer/demat of shares and failed to redress investor complaints pending for a long time.
- (iii) Ketan Parekh and certain other entities have been identified for their role in influencing the price movement in the scrip.

7.38 SEBI has stated that Prosecution Proceedings are being initiated in this regard and show cause Notice is also being issued to the company for violation of Takeover Regulations and Buyback Regulations. Action against broking entities is also being taken.

## 10. Pentamedia Graphics Ltd. (PGL)

7.39 The price of the scrip witnessed wide fluctuations ranging from a low of Rs.554 as on 1/11/1999 to a high of Rs.2272 on 22.2.2000. On the basis of information received from short listed trading members, SEBI has stated that none of the brokers had a concentration of more than 2.04% of the gross market purchases and 1.95% of the gross market sales during the period from October 1999 to June 2001.

7.40 The total equity capital of Pentamedia Graphics Ltd. had increased from 1.99 crore shares to 6.04 crore shares as on 30.9.2001 approx. an increase of 3.29 times on account of bonus issues, preferential issues and GDR issues. PGL has come out with three preferential issues during the past three years. In the first issue 29.30 lakh shares were allotted to 48 entities on 15.2.1999. In the second issue about 35.19 lakh shares were allotted to 5 entities on 22.12.2000. While in the third issue 10 lakh shares were allotted to only one entity viz. Malu Financial Securities Ltd. (MFSL) on 01.01.2001 which were under lock-in for one year up to 30.1.2002.

7.41 With regard to the issue of shares on preferential basis to MFSL, SEBI received a complaint from BSE alleging non-compliance of the guidelines regarding lock-in of shares allotted in the preferential issue after the listing permission was granted. It appears that the allottees viz. MFSL had advised the company to credit the shares to the depository account of Nikko Brokers Pvt. Ltd. with Centurion Bank and the company had complied with the instructions. Though the shares were under lock-in for one year till January 2002, Centurion Bank claimed that the shares have been pledged by Nikko Brokers with them for the credit facilities extended by the bank to Nikko Brokers Pvt. Ltd. The shares continued to be under lock-in and had not entered the market.

7.42 The Department of Company Affairs, in their inspection report have detected violations of sections 628/211, 13, 211, 217, 83, 209, 418, 212, 207, 257 of Companies Act, 1956 by the Company. DCA has reportedly ordered an investigation with regard to preferential allotment of 10 lakhs shares to MFSL.

## 11. Ranbaxy Laboratories Ltd.

7.43 SEBI's findings are summarized below :—

- (i) Some entities associated with the promoters of Ranbaxy Laboratories Ltd. had transacted in the scrip of Ranbaxy Laboratories Ltd. These entities appear to have sold in all approximately 32.92 lakh shares of Ranbaxy during the period from 1.1.1999 to 31.10.1999. After acquiring 15.43 lakh shares of Ranbaxy from the promoters of Croslands Laboratories Ltd. at a price of Rs. 597 per share, the promoters had resorted to selling a part of their holdings gradually aggregating to a total of about 27.25 lakh shares during the period May to October, 1999. The average selling price of the shares were reported to be approximately Rs. 750/- per share. This amount was stated to have been used for reducing the borrowings made by the promoters for acquiring Crosland Promoter Holdings as well as their other outstanding debts and payment of interest. In addition to the above, some of the entities of the promoter group realigned their shareholding *inter-se* in Ranbaxy involving about 8.8 lakh shares through sale and purchases. The arbitrage dealings by the promoter groups were to the extent of 1.84 lakh shares.
- (ii) Vidyut Investments Ltd., a subsidiary of Ranbaxy Laboratories Ltd., had funded the entities associated/connected with Ketan Parekh Group during the period 1.1.1999 to 31.10.1999 as well as in the subsequent period. SEBI, however, has observed in its inspection report that copies of the letters for credit facility granted by Vidyut Investments Ltd. to the associated entities of Ketan Parekh Group had stipulated that funds so granted as loan/line of credit would not be used directly or indirectly by the borrower to purchase shares of Ranbaxy Laboratories Ltd., as one of their conditions.
- (iii) CSFB aided, assisted and abetted in creating artificial volumes and false market in the scrip of Ranbaxy through circular trades and synchronized trades. Further Ketan Parekh Group entities/associates had entered into a large number of synchronized deals in the scrip within themselves and through the other brokers such as CSFB etc.
- (iv) A comparison of the price movement of the shares of Ranbaxy Laboratories Ltd. *vis-a-vis* those of other major scrips in the pharmaceutical industry namely, Cipla, Dr. Reddy's Laboratories, Lupin etc., during the period from 1.1.1999 to 31.10.1999 shows that the trend prices of these scrips was more or less uniform with that of Ranbaxy.

7.44 SEBI has stated that a reference has been received from Reserve Bank of India pointing out that one of the promoter companies namely Shimal Investments and Trading Company Ltd. had traded frequently in the shares of Ranbaxy. SEBI is looking into this matter.

7.45 SEBI has also stated that Adjudication Officer was appointed for conducting proceedings against the promoter entities of Ranbaxy Laboratories Ltd. for not informing SEBI regarding acquisition of 7.015% of the equity of the company during the period 1.1.1999 to 31.10.1999. Action against 41 broking entities for violation of various Regulations have also reportedly been initiated.

## 12. Shonkh Technologies International Ltd.

7.46 Shonkh Technologies International Ltd. is the new name of Shree Jee Yatayat Ltd. after the latter took over the entire business undertaking of an unlisted software company Shonkh Technologies Ltd. The price of the scrip witnessed significant volatility in the year prior to March 2001 and there appeared to be *prima facie* indications of market manipulation. SEBI's findings are as follows:—

- (i) There was *prima facie* evidence of broker promoter nexus. The controlling shareholders/ major shareholders of the company viz. Advance, Ankur and Padmini Technologies acting in concert with other companies namely DKG Buildcon, Churuwala Exports, Iris, Spectrum, Zodiac, Saral, Sanyo, Sadashiv, Mikona, R C Gupta & Company, etc. gave shares ostensibly on loan basis to Ketan Parekh entities which were finally used for creation of artificial market and market manipulations in the scrip.
- (ii) DKG Buildcon, Churuwala Exports, Iris, Spectrum, Zodiac, Saral, Sanyo, Sadashiv, Mikona, R C Gupta & Company, etc. appear to be shell companies. Some of these are not available at the addresses given by them, (Iris, Zodiac, Sanyo, Sadashiv, Spectrum). These companies appear to be connected with each other. Mikona and Iris are related through common director who is also director of Ankur. It was also seen that Ankur had sold shares to DKG, Churuwala and R. C. Gupta & Company at Rs.10 when shares being issued by the company at the rate of Rs.130 to 250 per share. Padmini Technologies had sold 25 lakh shares to Iris at Rs.142.50 per share on 27.12.2000, when the closing market price was Rs. 234. Padmini also sold another 2 lakh shares on 10.2.01 to Mikona for a price of Rs. 140/- per share when the market price was Rs. 289.90. SEBI has stated that it is inconceivable that a public limited company would sell its investment (Shonkh Technologies Int'l Ltd. shares) to an entity at a loss of around Rs. 25 crores. All these facts clearly show inter linkages between various entities which colluded with Ketan Parekh entities in creation of artificial market and market manipulations in the scrip of Shonkh Technologies Int'l Ltd.
- (iii) Ketan Parekh entities had received at one point of time around 50 lakh shares from the promoters and their associated shell companies. Later some of the shares were given back to lenders by Ketan Parekh entities when the market had already fallen. This clearly indicates that lending arrangement was not genuine and was merely receiving back of shares from the accomplices on failure of attempted offloading of shares at manipulated prices.
- (iv) Though synchronization of logging in of trades, circular trading and churning of the same stock, artificial volumes and false market were created. The fact that large stock was concentrated in the hands of a few entities which appear to be connected with promoters facilitated manipulation by Ketan Parekh entities. Ketan Parekh entities had around 41% of the paid up equity capital of the company. The concentration in the hands of a few entities was mainly on account of allotment of shares on preferential basis by unlisted company which became the basis of allotment of shares by Shree Jee Yatayat on acquisition of business of Shonkh Technologies Ltd.

### 13. Silverline Technologies Ltd.

7.47 The price of the scrip during the period from October, 1999 to March, 2000 witnessed a rise of 178% from Rs.364 to Rs.1013 and from March to June 2000, witnessed a fall of 395% (from Rs.933 to 564). SEBI has calculated that 172% out of 178% rise in the price of the scrip is attributable to the general Stock Market movement and only 6% can be said to be on account of other factors. As regards the fall in price, 124% out of 395% is attributable to general Stock Market movement and 271% fall is on account of other factors. SEBI's observations are summarised below:—

- (i) NSE had conducted an investigation into the trades of STL, for the time period 26.4.2000 to 27.6.2000 and has observed that the scrip is very liquid and from the client details provided by the various TMs, no apparent irregularities in trades could be established.
- (ii) The change in the shareholding of five OCBs—FRMAN Investments Pte. Ltd, Transatlantic Corporation Ltd., Americorp Holdings Ltd., BF Holdings Ltd. and DBMG of Mauritius—has been found to be significant. The purchases of the scrip made by these OCBs were vastly unrelated to their paid-up capital. The source of funds for these purchases as well as the beneficiaries of these trades needs to be examined to establish linkages, if any, among the brokers, the OCBs and others.
- (iii) Shri Ketan Parekh had executed large trades on behalf of an OCB—Brentfield Holding and executed trades on his own account as well as routed trades through one of his group companies. These trades of Shri Ketan Parekh and the trades executed by other OCBs need to be examined to establish linkages, if any, among the brokers, the OCBs, and others.

### 14. SSI Limited

7.48 During the period from 1.10.1999 to 10.3.2000, the price of the scrip of SSI moved up approx. from Rs.650 to Rs.5380 i.e. a rise of 727%. From 13.3.2000 to 9.6.2000, the price of the scrip fell from Rs.4950 to Rs.2700 i.e. a fall of approx. 454%. SEBI has stated that only 131% out of 727% rise in the price of SSI can be attributed to the general Stock Market movement and the rest is said to be on account of factors specific to the company. Similarly only 131% out of 454% fall in the price of SSI can be attributed to the general Stock Market movement. The observations of SEBI in this regard are summarised below:—

- (i) The holdings of the Promoters/Persons acting in concert has been found to have undergone change mainly on account of issue of bonus in the ratio of 1:1.
- (ii) Two OCBs—FRMAN Investments Pte. Ltd. and Transatlantic Corporation Ltd., each having a paid up capital of US \$ 1000 had made transactions of about Rs.14 crore and 13 crore respectively. The source of funds for these purchases as well as the beneficiaries of these trades needs to be examined to establish linkages, if any, among the brokers, the OCBs and others.
- (iii) Shri Ketan Parekh had executed large trades on behalf of an OCB—Brentfield Holding; executed trades on his own account as well as routed trades through one of his group companies. These trades need to be further examined. Further, the trades executed by other OCBs also need to be examined to establish linkages, if any, among the brokers, the OCBs and others.

7.49 The inspection conducted by the Department of Company Affairs has brought out violations of the various provisions of the Companies Act, 1956 viz. Sections 227, 217 300, 302, 211, 212, 301, 159, 58 etc.

#### 15. Zee Telefilms Ltd. (ZTL)

7.50 The price of the scrip moved from Rs.476 on 1.10.1999 to Rs.1555 on 24.2.2000. The price of the scrip was Rs.121 as on 30.3.2001. The summary of SEBI's observations on the basis of its investigation so far is as follows:—

- (i) In September, 1999, ZTL acquired Zee Multimedia Worldwide Limited (ZMWL) through which all the global media assets of the Essel Group were brought under its ownership and control. It has been observed that the ZTL has obtained approval from Reserve Bank of India and FIPB for acquisition of ZMWL shares and allotment of ZTL shares.
- (ii) ZTL allotted about 1.61 crore shares to Asia Productions Ltd., International Graphics Holdings (Mauritius) Ltd., News Television Mauritius Ltd., and News Television (India) Ltd. for acquisition of 50% stake each in Winterhealth Company Ltd.—British Virgin Islands, Sificable Network Ltd. India and Programming Asia Trading Company Pvt. Ltd. India, by way of deferred credit and issue of shares of ZTL. ZTL obtained approval from Reserve Bank of India for the acquisition and allotment of ZTL shares.
- (iii) 80 lakh equity shares of Re.1/- each at a premium of Rs.999/- per share were allotted to Goldman Sachs Investment (Mauritius) I Ltd., (GSIMI) on preferential basis in the year 2000.
- (iv) The investment and trading Concerns of the Essel Group have given an amount of Rs. 706.40 crores to the entities related to Ketan Parekh during the period from 2.5.2000 to 25.4.2001 out of which an amount of Rs. 251.55 crores were returned back. The balance amount receivable is Rs. 454.85 crore. The available data of financial dealings indicate that the flow of funds between the two groups started only when the price of the scrip was on a descending trend and not during the period of price rise.
- (v) It appears that the KP Group did not utilize the funds given by the Essel Group to the KP entities in part or full for the purpose for which it claimed to have been given viz. for purchase of certain media related shares. The Essel Group while providing ICDs on commercial terms took a firm undertaking from the KP Group that the KP Group would not use the money provided by the Essel Group to make purchase of shares of Zee Telefilms Limited and Essel Packaging Limited, the listed companies of the Essel Group. The Essel Group has reportedly initiated legal action against various KP Group entities for non-repayment of ICDs, non-delivery of shares against purchases made in the stock market and non-performance of the agreement. The Mumbai High Court passed an order injuncting the KP Group company from alienating, transferring, dealing with or disposing of the shares agreed to be transferred by the Company to Churu Trading Company—an Essel Group Company.
- (vi) The Essel Group companies have not dealt with the shares of ZTL during the period 1.4.1999 to 31.3.2001.
- (vii) All the three broker groups of CSE who were declared defaulters namely, H C Biyani, Singhanian and Poddar Group actively traded in the ZTL scrip. KP entities apparently were one of the significant contributors towards trading volumes executed by D. K. Singhanian Group and Poddar Group at CSE. Ketan Parekh entities have entered into structured deals/cross deals in NSE and BSE and have, thereby, aided and abetted in manipulation of prices and creation of artificial volumes.

7.51 SEBI furnished four sets of interim reports inclusive of its investigation regarding scrips of certain corporate bodies. The Committee's insistence for SEBI's final findings regarding the role of promoters/corporate bodies in the price manipulation of the scrips yielded yet another set of reports most of which were again of interim nature and were received as late as in November 2002. Due to non-availability of Final Report from SEBI, the Committee could not have the opportunity to take oral evidence of these corporate bodies. The Committee urge SEBI, the Department of Company Affairs and other investigative agencies to expedite and complete their investigations into involvement of promoters/corporate houses in manipulation of prices of scrips which were found to have undergone unusual volatility. The Government should take appropriate action under the provisions of the relevant laws on the basis of outcome of their findings. Expeditious action should be taken against those involved wherever the involvement of promoter/corporate house is established.

7.52 The Committee note that SEBI has not completed its investigation in most of the cases even 18 months after taking up the cases for enquiry. The Committee feel that there should be reasonable time frame for concluding investigations that have bearing on the health of the capital markets. The Committee desire that SEBI must examine the matter and fix a time frame for investigations as part of its regulations/procedures. SEBI has stated that further evidence against other broker entities, promoters etc. are being recorded and quasi judicial proceedings are in progress. SEBI has further stated that a final view in the matter would be taken after gathering evidence during the course of cross examination of charged entities and on completion of quasi judicial proceedings.

7.53 Having learnt about the ingenious ways of transferring funds by certain companies to manipulate the market, SEBI has now made certain suggestions to prevent proliferation of shell companies. In order that the scope of registering shell companies with fictitious details about their initial subscribers/promoters, their addresses etc., appropriate revisions in the rules as well as in the forms prescribed under the respective rules also need be effected by Registrar of Companies and other statutory authorities in the existing ones and introduce adequate verification of the details furnished in applications for registration of companies, without delay. The SEBI suggestions include yearly declaration by companies about floating of subsidiary/associate companies, etc., disclosure on quarterly basis about change in investments by the subsidiaries/associate companies, restriction on floating investment companies by a parent company and verification of the antecedents of the persons behind the investment companies. SEBI has also suggested regulation of reverse merger where an unlisted company merges with a listed company on non-transparent manner. The Committee are of the view that these suggestions merit urgent examination and follow up action by the Government . The Committee also feel that the issues concerning preferential allotment and private placement also need to be looked into afresh by DCA and SEBI in the light of the SEBI's findings in this regard with a view to take suitable corrective measures.

7.54 This Committee hold that even as there are valid reasons to believe that the corporate house-broker-bank-FIIs nexus played havoc in the Indian capital market quite sometime now through fraudulent manipulations of prices at the cost of the small investors, this Committee were severely handicapped in the matter of making any purposeful recommendations because of non-availability of required support from concerned regulatory and other bodies with necessary material. The issue acquires added importance in view of the recommendations of the 1992 JPC regarding the urgent need to go into this unhealthy nexus of corporate entities-brokers-banks and others.

## CHAPTER VIII

### OCBs AND SUB-ACCOUNTS OF FILs

#### A. BACKGROUND

##### (i) Overseas Corporate Bodies (OCBs)

8.1 Overseas Corporate Bodies (OCBs) include overseas companies, partnership firms, trusts, societies and other corporate bodies owned either directly or indirectly to the extent of atleast 60% by Non-residents of Indian nationality/origin. As on 31.12.2001, there were 664 OCBs operating in India under Portfolio Investment Scheme (PIS).

8.2 Portfolio Investment Scheme (PIS) for NRIs/OCBs came into effect with the RBI circular dated April 14, 1982 under Section 73 (3) of Foreign Exchange Regulation Act, 1973. In terms of this circular, the entire gamut of facilities of direct and portfolio investments were extended to OCBs. OCBs intending to transact in shares/Debentures had to submit a certificate regarding non-resident ownership in form OAC from Overseas Auditor/Chartered Accountant/Certified Public Accountant along with their application for investment in shares, to the RBI, either through the designated banks authorized to deal in foreign exchange or the Indian companies offering new issues, as the case may be. From the year 1982 to 1999, RBI had granted permission to 1080 OCBs to purchase/sale shares under PIS through an Authorised Dealer. With effect from 1st November, 1999, authorized dealers have been given authority to grant permission to OCBs to invest under PIS. RBI has stated that no data is available regarding permission granted by ADs from November, 1999 onwards.

8.3 The salient features of the Portfolio Investment Scheme (PIS) as applicable to OCBs, as evolved over the years, are as follows :—

- (i) *Operations to be through only one designated branch of a bank;*
- (ii) *The holdings by each OCB, on repatriation and on non-repatriation basis, should not exceed 5% of the paid up value of shares issued by the Indian company;*
- (iii) *The aggregate paid up value of shares in any single company, purchased by all NRIs and OCBs taken together, should not exceed 10 per cent of the paid-up capital of that company. The aggregate ceiling of 10 per cent may be raised to 24 per cent if a special resolution to that effect is passed by the General Body of the Indian company concerned;*
- (iv) *The OCB must take delivery of the shares purchased and give delivery of shares sold. No short sales are allowed;*
- (v) *Payment for purchase of shares and/or debentures is to be made by inward remittance in foreign exchange through normal banking channels or out of funds held in NRE/FCNR account maintained in India if the shares are purchased on repatriation basis and by inward remittance or out of funds held in NRE/FCNR/NRO/NRNR/NRSR account of the NRI/OCB concerned maintained in India where the shares/debentures are purchased on non-repatriation basis.*

8.4 The Foreign Exchange Regulation Act was repealed from 1.6.2000 and substituted by Foreign Exchange Management Act (FEMA). The position with regard to OCBs continues to be the same under FEMA.

8.5 According to RBI, data is collected by them on a daily basis, from the designated branches of the Authorised Dealers (AD) in respect of sale and purchase of shares of Indian companies with a view to monitoring the respective aggregate limits for investment in Indian Companies by FIs (24%/30%/40%/49%) and the NRI/OCB limits (10%/24%).

#### **(ii) Sub-accounts of FIs**

8.6 Foreign Institutional Investor (FII) is an institution established or incorporated outside India which proposes to make investment in India in Securities. "Sub-account" include foreign corporates or foreign individuals and those institutions, established or incorporated outside India and those funds or portfolios, established outside India, whether incorporated or not, on whose behalf investments are proposed to be made in India by a FII. FIIs are allowed to invest in Indian Securities Market since September 1992.

8.7 SEBI notified Foreign Institutional Investors Regulations on November 14, 1995. The registration of Foreign Institutional Investors and their sub-accounts is currently being done by SEBI under these Regulations.

8.8 As on April 30, 2001, 526 FIIs were operating in India, either directly or through their 1339 sub-accounts incorporated elsewhere. The FIIs have made a net investment of Rs. 51,860 crore (US\$13.82 billion). A cumulative net investment of Rs. 15,524 crore has been made by 85 FIIs through their 161 sub-accounts having Mauritius as their tax jurisdiction.

8.9 The FIIs can invest on behalf of sub-accounts or invest their proprietary funds. Sub-accounts cannot directly invest in India. They have to route their investments through FIIs. A domestic portfolio manager or domestic asset management company is now also eligible to be registered as an FII to manage the funds of sub-accounts incorporated/set-up abroad.

8.10 FIIs are required to :

- (a) appoint a domestic custodian for custody and settlement of securities;
- (b) enter into an arrangement with a designated bank for the purpose of operating a special non-resident rupee or foreign currency account;
- (c) conduct trade only through SEBI registered brokers;
- (d) do delivery based trading only.

8.11 The custodians are required to submit the details of FII transactions on a daily basis to SEBI as well as to RBI.

8.12 An FII/sub-account can invest upto 10% of the paid-up capital of a company and all FIIs/sub-accounts put together can invest upto 24.49% of the paid-up capital of a company with the approval of shareholders in General Meeting. A foreign corporate or a foreign individual as a Sub Account can hold upto 5% of the paid-up capital of the company. NRIs and OCBs are not permitted to invest through FII route. According to SEBI regulations, a non-resident Indian or an OCB is not eligible to invest as sub-account or as FII.

8.13 SEBI's findings regarding OCBs and Sub-accounts of FIIs contained in its interim reports are discussed issue-wise in this Chapter.

## B. IRREGULARITIES

8.14 SEBI in its interim reports has identified 14 OCBs and 4 Sub-accounts of FIs which have done large transactions in certain scrips associated with Shri Ketan Parekh. Several instances of non-adherence of RBI guidelines have been reported by SEBI in respect of seven OCBs viz. Kensington, Brentfield, Wakefield, European, Far East, Almel and Rafs Corporation. These violations are :—

- (a) Transactions of OCBs with OCBs and with Indian entities other than through registered stock brokers (out of stock exchange transactions).
- (b) Sale and purchase of shares by OCBs without actual deliveries.
- (c) Purchase of shares by OCBs on adjustment basis without fund flow from their accounts to the brokers accounts.
- (d) OCBs booking purchase orders without sufficient balances in their respective accounts.
- (e) Exceeding the 5% CEILING as prescribed for individual OCBs.
- (f) Violations of 10% aggregate ceiling norm by OCBs in three Indian companies.

8.15 Other violations by OCBs and Sub-accounts of FIs as reported by SEBI are as under :

- (i) *The trading pattern of the identified OCBs reveals that they have concentrated in a few scrips. Further, instances of circular trading and parking of shares have also been noticed. The outgo of funds through OCBs has also been substantial. Ketan Parekh entities misused the FI sub-accounts and OCBs for market manipulations, building of concentrated positions, creating artificial market, circular trading, circumventing Takeover regulations, issue of Participatory Notes, etc.*
- (ii) *Investigations in some of the scrips—Mascon Global, Shonkh Technology, Aftak Infosys, Adani Exports, Global Trust Bank, Lupin Laboratories brought out that Ketan Parekh entities used OCBs and sub-accounts of FIs for parking of shares, circular trading, building up concentrated position, creating artificial market, circumventing Takeover Regulations, etc. Five OCBs namely Kensington, Brentfield, Wakefield, Far East and Almel and two sub-accounts namely Coral reef, a Sub-account of the FI RP & C International, Kallar Kahar a Sub-account of the FI Credit Suisse First Boston were found to have aided, assisted and abetted in creation of artificial market & volumes, circular trading and building up concentrated position in the above mentioned scrips. The transactions showed that above mentioned OCBs and Sub-accounts were used by Ketan Parekh entities to park shares for a short period and for circular trades. It was also seen that these transactions were synchronized deals which were put in such a way that shares sold by Ketan Parekh entities were purchased by a particular OCB/Sub-account and when these OCB/Sub-accounts sold back shares through synchronized transactions these were purchased only by Ketan Parekh entities. Such matched transactions created artificial market and volumes especially in illiquid scrips. It is important to note that on many occasions Ketan Parekh used to coordinate the buy and sell transactions of OCBs/Sub-accounts which indicate the unusual proximity between them. These matched deals were in gross abuse of the trading system and they hampered efficient price discovery. The large buy orders and synchronized trades which formed substantial volume of the total volumes traded in these illiquid scrips also led to bench marking of prices of these scrips. This also led others to purchase and sell these shares. Apart from artificial building up concentrated position; OCBs and Sub-accounts also violated the provisions of SEBI (Substantial Acquisition of shares and Takeover) Regulations, 1997. It was also noticed by SEBI that financing transactions were given the colour of purchase and sale of shares.*

8.16 On receipt of SEBI's preliminary findings on 31st May 2001, RBI undertook an inspection of the Nariman Point and Fort, Mumbai Branches of Global Trust Bank (GTB) the designated branches of GTB, for investments by five OCBs viz. European Investment Ltd., Far East Investment Ltd., Wakefield Holding Ltd., Brentfield Holdings Ltd., Kensington Investment Ltd., under Portfolio Investment Scheme (PIS) in July 2001. The focus of the inspection was to ascertain that the terms and conditions, subject to which OCBs were permitted to invest under PIS, were being strictly followed by GTB.

8.17 The findings of the Inspection are as under :-

- (i) *There are several instances where the OCBs had booked purchase orders, without having sufficient balances in the NRE/A/c.*
- (ii) *The OCBs had made payments by debit to their NRE Accounts. However, the shares had not been received by OCBs in a few instances.*
- (iii) *Far East Investments Corporation Ltd. had received the payment for 2,95,000 shares of HFCL shares sold; however, the OCB has delivered only 2,35,000 shares.*
- (iv) *The OCBs had received the shares but they have not made payments for purchase of the shares in some cases.*
- (v) *The OCBs had sold the shares but they have not received the payments in a few cases.*
- (vi) *Kensington Investments Ltd. purchased 16,50,000 shares of HFCL in June 2000 for which brokers contract notes were produced. No payment for these shares was made. These shares were immediately transferred to Wakefield who sold these in 5 days in June/July 2000 and remitted the proceeds amounting to Rs. 253.36 crores on the dates of sale itself. Wakefield Holdings Ltd. paid for the shares about four months later. The irregularities appear in :—*
  - (a) *Buying of shares by Kensington on credit basis.*
  - (b) *Sale by Wakefield Holdings Ltd. appears to be outside Stock Exchange, as the amount of sale proceeds cannot be credited on the same day, if the shares are sold on stock exchange.*
- (vii) *The Copy of the agreement between Bretifield Holdings Ltd., Mauritius and M/s Mastek Holdings Corporation, U.S.A. for transfer of 10,00,000 shares of Mascon Global from Mastek Holdings Corporation to Brentfield Holdings for payment/settlement overseas was not available with the bank.*

*The supporting documents in respect of transfers from other OCBs to Brentfield Holdings Ltd. in respect of 10,50,000 shares of Global Telesystems as detailed below, were not available with the bank.*

<i>Date of transaction</i>	<i>No. of shares</i>
<i>19.6.1999</i>	<i>4,25,000</i>
<i>14.9.1999</i>	<i>3,75,000</i>
<i>24.2.2000</i>	<i>2,50,000</i>

8.18 It was also found that the bank had no system to monitor the prescribed ceiling of 5% holdings by individual OCB in any company for the transactions relating to the period under inspection.

8.19 To a specific query from this Committee seeking RBI to draw to the attention of the Committee specific regulations/guidelines which require the OCBs to keep full funds available in the account before initiating the Purchase Order, RBI has clarified that any purchase of shares without sufficient balance in the non-resident investor's account on the date of "delivery of shares" purchased would result in extension of credit to non-resident investors which is not permissible under the Exchange Control Regulations. There is thus a shift in time of funds availability from "Purchase Order" to "delivery of shares". In view of the above clarifications the reported irregularity of OCBs booking purchase orders without sufficient balances in their respective accounts would no longer be categorized as an irregularity.

8.20 To a series of further queries from this Committee, RBI has stated that permission under PIS was granted to authorized dealers (i.e. Banks) to buy and sell shares, etc. on behalf of their OCB/NRI clients. RBI has again clarified that the regulations do not preclude NRI/OCBs from appointing stock brokers as their agents for sales/purchases of shares on a recognised stock exchange through a registered stock broker. NRI/OCBs are permitted to appoint stock brokers as their agents.

8.21 To a specific query from the Committee whether "non delivery of shares by brokers purchased by OCB client or non-receipt of payment from brokers for shares sold and delivered by OCB client are irregularities of OCB and whether an AD can be held responsible by the regulator or OCB for non-performance of broker", RBI has clarified that the broker is an agent for the purchaser of shares i.e. OCB. Since the transaction is entered on behalf of the OCB, the OCB may be considered to be responsible for any irregularity in the transaction\*. Further AD's responsibility is limited to the undertaking to ensure that shares/debentures to be purchased through a recognised stock exchange in India in conformity with the terms and conditions of approval to buy shares under portfolio investment scheme (PIS).

8.22 In light of the above clarification, the irregularities attributed to GTB in this regard would no longer be categorized as irregularities. This is because the original irregularities have been identified on the assumption that PIS permission is only for Authorised Dealers to transact "on behalf of OCBs". In view of the clarification that OCBs are not precluded from dealing with brokers, as the transaction would be directly from an OCB to a broker, the Bank cannot be held responsible for OCB having committed the irregularity. Further RBI has also clarified that the responsibilities of Authorised Dealers are limited, as stated above. Hence the above irregularities will be that of the OCBs only and not of the Bank. The Committee also recognizes where an OCB directly makes purchases through a broker, any breach of 5% regulation will only be known to the Bank when the transaction affects the money account with the Bank. Hence in case of breach of 5% restrictions, while the OCB will be responsible for the same, Banks can only pursue rectification.

8.23 Informing the action taken on its inspection findings, RBI has stated that it has written to Global Trust Bank Ltd. to submit their compliance in respect of the inspection findings within one month. The bank has been advised to put systems in place for implementation /monitoring of transactions under Portfolio Investment Scheme. Global Trust Bank Ltd. has also been advised that in the interim period they should not open any new accounts on behalf of OCBs until there are systems in place for implementation/monitoring of PIS to the full satisfaction of their Board. Further, with regard to the existing OCB clients, the Chairman of Global Trust Bank Ltd. had been advised to appoint a designated officer to approve the PIS transactions of such OCBs. The designated officer was to be responsible for ensuring that the transactions under PIS are in conformity with the FEMA regulations. GTB has also since submitted an external Auditors Certificate to say that all the transactions relating to PIS have been carried out in conformity with the rules and regulations.

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\*At the time of factual verification Ministry of Finance suggested for inclusion of the following:

"Unless there has been a violation of the Stock Exchange/SEBI regulations by the Bank or a breach of instructions given by the OCBs for purchase of shares."

8.24 As far as wide gap between inflow and outflow in accounts of 5 OCBs maintaining account with GTB is concerned, the bank, through a letter dated June 29, 2001 from M/s Yashpal Kumar & Co., a Chartered Accountancy Firm addressed to the Securities & Exchange Board of India (SEBI), had given an explanation that the outflows were also on account of sale of shares obtained under FIPB approval, shares that were purchased from other OCBs outside India and underlying shares obtained by conversion of ADRs/GDRs.

8.25 Taking note of the violations of RBI guidelines by the OCBs investigated by SEBI, the Committee desired to know the genuineness of the transactions by these OCBs in the capital market. In response, the Governor, RBI assured during oral evidence to get a sample check conducted to verify the genuineness of their transactions. RBI accordingly conducted a scrutiny of around 100 transactions of OCBs to verify whether the transactions have actually taken place. A sample of 100 transactions was taken up for scrutiny from 604 transactions reported to SEBI by M/s Yashpal Kumar & Co., Chartered Accountants by letter dated 29 June, 2001. The sample covered 70% of the value of transactions, covered by M/s Yashpal Kumar & Co. RBI's scrutiny of these transactions revealed that the transactions were actually undertaken.

8.26 As regards the genuineness of transactions of a large number of other OCBs which were not investigated by SEBI, a representative of RBI informed the Committee on 08.04.2002 that all the banks have submitted their Auditor's certificate to say that all the transactions relating to portfolio investment scheme have been carried out in conformity with the rules and regulations.

8.27 SEBI's investigations have dealt with the cases where a lone OCB exceeded investment ceiling and violated SEBI's Take Over Code. There could also be cases where a same set of individuals who have formed more than one OCB and have their investments in Indian securities market spread across those OCBs in such a way as not to attract the provisions of Take Over Code.

8.28 SEBI has stated that OCB route of Portfolio Investment had been misused by certain entities and there has been more outflow than the inflow through this route. Instead of serving the purpose of bringing in foreign exchange in the country, the purpose got defeated on account of large outflows. It was further stated that on the basis of *prima facie* findings of involvement of some of the OCBs in aiding, assisting and abetting Ketan Parekh entities in market manipulations. SEBI recommended to the Government that this facility of portfolio investments provided to OCBs, need to be withdrawn. This suggestion of SEBI has been accepted by the Government and OCBs have since been prohibited from investing in secondary market through portfolio investment route by RBI.

8.29 In regard to the action taken on irregularities SEBI has mentioned that Kallar Kahar a Sub-Account of CSFB had violated the Regulation 7(2) of SEBI (Substantial acquisition of shares & Takeover) Regulations, 1997 where in it has been specified that the acquirer is required to intimate the target company on acquiring 5% of the paid up equity of the target company. Adjudication proceedings under section 15A of SEBI Act, 1992 is proposed to be initiated against Kallar Kahar. SEBI has mentioned that adjudication proceedings for similar violations have already been initiated against Brentfield, Kensington, European and Far East. As regards any other action under section 11B of SEBI Act read with section 11 of SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 1995 against OCBs is concerned, matter is reportedly being examined legally. OCBs have already been prohibited from investing through Portfolio Investment route in securities market by circular of RBI. Investigations in respect of Sub-Accounts of FIs (Coral Reef and Kallar Kahar) are stated to be in progress and a view would be taken on completion of the same.

8.30 Action taken against Shri Ketan Parekh, Shri Kartik Parekh and their associate broking entities is discussed elsewhere in this report. Quasi judicial proceedings are in progress against non-intermediary entities of Ketan Parekh which were found involved in Market manipulations namely Classic Credit, Panther Fincap Management Services Ltd, Luminant Investments Ltd, Panther Invest Trade Ltd. and Sai Mangal. Enquiry proceedings in respect to some of the brokers namely Latin Manharlal, Hem Securities Limited, C.J. Dalal who aided, abetted and assisted Ketan Parekh in market manipulations have also been initiated.

8.31 On the question of action taken against OCBs for their violations, the Enforcement Directorate stated in a reply furnished in August 2002 that the Global Trust Bank and OCBs have been charged under the Foreign Exchange Regulation Act, 1973 for violation in respect of transactions up to 31.05.2000. These violations are as under :-

- (i) *M/s Brentfield Holdings Ltd. has been charged for taking their holdings in the Aftel Infosys upto 15.02% i.e. 10.2% in excess of the prescribed ceiling of 5% in the individual scrip, thereby violating the provisions of section 29(1) (b) of the Foreign Exchange Regulation Act, 1973. In the case of M/s Global Trust Bank and its officials to whom the permission was issued by the RBI on behalf of the said Brentfield Holdings Ltd. they have been charged for their failure to comply with the terms and conditions of RBI as mentioned in Para 10C.21 of Exchange Control manual and thereby in terms of section 49 of the Foreign Exchange Regulation Act, 1973, they appear to have contravened the provisions of section 29(1) (b) of the said Act.*
- (ii) *Global Trust Bank Ltd. and its officials have been charged for not questioning the OCBs or advising them to desist from booking purchase orders without having sufficient balance in the accounts or taking declarations to that effect and thereby contravening the provisions of section 6(5) of Foreign Exchange Regulation Act, 1973. M/s Brentfield Holdings Ltd., M/s Wakefield Holdings Ltd., M/s European Investments Ltd., M/s Far East Investment Corporation Ltd. and their Power of attorney holders (P.O.A.) have been charged for abetting the said Global Trust Bank in the said contravention.*
- (iii) *M/s European Investments Ltd. and its POA, have been charged for making a purchase of 829,987 shares of SAIL for a total amount of Rs. 109,24,241/- on credit basis and not taking delivery of the said shares of SAIL and thereby failed to comply with the terms and conditions of RBI as mentioned in Para 10C.21 of the Exchange Control Manual and thereby contravening section 29(1) (b) of Foreign Exchange Regulation Act, 1973 read with the provisions of section 49 of the said Act.*

8.32 Enforcement Directorate has informed that complaints relating to these charges have been filed and show cause notices issued. The charges will cover contraventions relating to (i) payments made but shares not received, (ii) sale of shares but not actually delivered, (iii) non-payment of money against shares received, (iv) purchase on credit basis, (v) credit limits and (vi) placement of purchase orders without having sufficient balance to their credit.

### **C. FLOW OF FUNDS**

8.33 According to SEBI, the OCB route of Portfolio Investment has been misused by certain entities and there have been more outflows than the inflow through this route. Instead of serving the purpose of bringing in foreign exchange in the country, the purpose got defeated on account of large outflows. Some of the OCBs had very nominal share capital ranging from \$ 1 to \$ 10,000, yet their investment in Indian Capital Market was very large running into millions

of dollars. SEBI had stated that the net outward remittances of 13 OCBs during the period from 1 April 1999 to 31 March 2001 were approximately Rs. 3850 crore as under:-

Name of the OCB	Inflow (Rs. in Crore)	Outflow (Rs. in Crore)	Netflow (Rs. in Crore)
Brentfield Holdings Ltd.	109.12	663.31	(554.19)
Kensington Investment Ltd.	79.11	423.80	(344.69)
Wakefield Holding Ltd.	234.66	2228.73	(1994.07)
European investment Ltd.	421.32	368.90	52.42
Far East Investments Ltd.	81.07	330.19	(249.12)
Almel Investment Ltd.	44.76	194.30	(149.54)
Viceroy Investment Ltd.	24.87	NIL	24.87
Green Filed Investment Ltd.	6.50	147.92	(131.42)
Guardian Financial Limited	6.45	NIL	6.45
Symphony Holdings Ltd.	NIL	9.06	(9.06)
Rafs Corporations Ltd.	NIL	33.17	(33.17)
Dossier Stock Incorporation	6.69	NIL	6.69
Delgrada Limited	NIL	476.12	(476.12)
<b>Total</b>			<b>(3850.97)</b>

8.34 In a post evidence reply submitted to the Committee RBI informed that it had conducted a sample study of the total inflow and total outflow of funds from the accounts of OCBs as reported by their designated bank. The sample study covered the inflows/outflows by 209 OCBs through 5 ADs (one public sector bank, 2 private sector banks and 2 foreign banks). The purpose of the study was to ascertain the total inflows by each OCB from the date of its opening of the account with the designated bank and the total outflows from such account till date. The designated bank was also required to indicate the paid up share capital of the OCB, if available. Findings of the Study are tabulated below:-

Name of the Bank	No. of OCBs Reported	No. of OCBs with PUC of <US\$ 100	No. of OCBs with PUC of >US\$ 1,00,000	No. of OCBs in respect of which PUC not available	Inflow in US\$(mn.)	Outflow in US\$(mn.)
Union Bank	59	13	5	—	61	377
ICICI Bank	33	13	4	—	33	162
IndusInd Bank	51	6	2	—	110	134
Deutsche Bank	45	12	2	19	605	506
HSBC	21	4	4	—	225	85
<b>Total</b>	<b>209</b>	<b>48</b>	<b>17</b>	<b>19</b>	<b>1034</b>	<b>1264</b>

PUC—Paid-up Capital; mn-million.

8.35 The sample study of RBI revealed that out of 190 OCBs in respect of which paid-up capital figures are available, 48 OCBs are reported to have paid-up capital of US \$ 100 or less. Of these 18 OCBs had paid-up capital of US \$ 10 or less. Only 17 OCBs have paid-up capital of US \$ 1,00,000 or more.

8.36 From the table above, it may be observed that whereas the total inflow by 209 OCBs was US \$ 1034 million, the total outflow was US\$ 1264 mn.—showing a net outflow. However, in interpreting this data, one has to keep in mind that this may include sales/repatriation of underlying shares acquired through ADR/GDR route for which there is no matching inflow under this data.

8.37 ADR stands for “American Depositary Receipt” and GDR stands for “Global Depositary Receipt.” ADRs/GDRs are instruments in the form of a depositary receipt or certificate created by the Overseas Depositary Bank (a bank authorized by the issuing Indian company to issue Global Depositary Receipts) outside India and issued to non-resident investors against issue of ordinary shares of the Company. The ADRs are depositary receipts listed with NASDAQ or New York Stock Exchanges and GDRs are depositary receipts normally listed on London or Luxembourg Stock exchanges.

8.38 According to RBI, the OCBs can have outward flows much larger than inflow reported under the Portfolio Investment Scheme for the following reasons:

- (i) *The OCB can purchase ADRS/GDRs outside India from its foreign exchange resources and then later convert these ADRs/GDRs into underlying shares and sell them in the Indian market and repatriate the proceeds in terms of General Permission available.*
- (ii) *The OCB can purchase Foreign Currency Convertible Bonds (FCCBs) issued by Indian companies outside India and then later convert FCCBs into shares and can sell them in the stock exchange in terms of General Permission available.*
- (iii) *There is General Permission available to NRIs/OCBs to transfer shares to one another outside India. Thus, it is possible that an OCB can purchase shares from another OCB outside India and then later sell these shares on a stock exchange under the General Permission.*
- (iv) *In certain cases, FIPB and the Special Committee on Overseas Investment grant permission to Indian companies to acquire overseas company by way of SWAP and purchasing shares of the Indian Company in such cases. The overseas acquirer who may be an OCB may later sell these shares on the Indian stock exchange and repatriate these amounts under the General Permission available.*

8.39 There was a suggestion that SEBI’s finding about net outflow by OCBs was contradicted by the Enforcement Directorate. In order to get a correct picture about this aspect, the Committee obtained a reconciliation statement from the Enforcement Directorate (ED).

8.40 In the reconciliation statement, the ED has stated that the SEBI has arrived at the figures of inflow and outflow, during the period April 1st, 1999 to March 31st, 2001, only on the basis of the actual inward remittance into and outward remittance from the Bank accounts of the

OCBís and Enforcement Directorate concurs with these figures which are as follows :-

(Rs. in crore)

Sl.No.	Name of the OCB	Inward Remittance	Outward Remittance	Net outflow as per SEBI
01.	Brentfield Holdings Ltd.	109.12	663.31	554.19
02.	Kensington Investments Ltd.	79.11	423.08	344.69
03.	Wakefield Holdings Ltd	234.66	2228.73	1994.07
04.	Symphony Holdings Ltd.	NIL	9.06	9.06
05.	Rafs Corporation	0.33	33.17	32.67
06.	Al-Mel Investments Ltd.	44.75	203.09*	159.15

\* The difference in figures of SEBI and ED is on account of different time frame taken for calculating the inward and outward remittance.

8.41 The figures during the aforesaid period according to investigations of the Enforcement Directorate are as under :-

(Rs. in crore)

Sl. No.	Name of the OCB	Sale proceeds of shares which were acquired pursuant to conversion of ADR/GDR issues into underlying shares (Non-PIS transactions)	Sale proceeds of shares sold which were acquired by overseas settlement other than ADR/GDR mode	Total sale proceeds of shares acquired by ADR/GDR conversion and overseas settlement Rupees in Cr.	Net outflow as per statement of SEBI	Difference (5)–(6)
1	2	3	4	5	6	7
1.	Brentfield Holdings Ltd.	63.93	605.09	669.83	554.19	115.64
2.	Kensington Investments Ltd.	0.40	820.98	821.38	344.69	476.69
3.	Wakefield Holdings Ltd.	Nil	2004.65	2004.65	1994.07	10.58
4.	Symphony Holdings Ltd.	9.08	Nil	9.08	9.06	0.02
5.	Rafs Corporation	33.28	Nil	33.28	32.67	0.61
6.	Al-Mel Investments Ltd.	16.52	98.36	114.88	159.15	44.27
	Total	123.21	3529.02	3652.23	3083.83	548.11

8.42 The figures in columns (3) and (4) of the foregoing Table refer to the sale proceeds on account of non-PIS (Portfolio Investment Scheme) transactions which can be utilized towards

re-investment in India or remittance out of India or partly in both manners. The SEBI's net outflow figures are based on the difference between the inward remittances and outward remittances from the bank accounts which can be both on account of PIS or non-PIS transactions. Thus, the figures in column (5) are not comparable with those in column (6) in real terms.

8.43 The E.D. has therefore stated that the inference drawn in the news item regarding the net inflow is misleading.

8.44 The break-up of PIS transactions regarding sale and purchase by OCB's are given below:—

Rs. in crore		
Name of the OCB	Total Purchase	Total Sales
1. Brentfield Holding Ltd.	302.16	230.38
2. Kensington Investment Ltd.	955.92	549.05
3. Wakefield Holdings Ltd.	1282.15	1314.26
4. Symphony Holdings Ltd.	Nil	Nil
5. Rafs Corporation	0.57	1.60
6. Al Mel Investments Ltd.	147.47	175.49

8.45 Indicating the reasons for huge disparity between inflow and outflow of funds by OCBs, the Enforcement Directorate has stated that the inflow figures shown in the SEBI report did not include the following transactions:

- (a) Conversion of ADR/GDR issues into underlying shares of the OCBs.
- (b) Preferential allotment in which the OCBs have directly sent money from abroad to the issuing companies.
- (c) OCB to OCB transfers.

8.46 It appears that while calculating the outflow, SEBI has included the sale proceeds of these shares referred from (a) to (c) above, and hence there is huge disparity.

8.47 According to the Enforcement Directorate, purchase value of shares on account of above types of transactions either cannot be determined or is not known. Similarly, the details of remittance received are not known in respect of the following categories:

- (a) Subscription received at the time of issue of ADR/GDR by the Indian companies.
- (b) Remittances received by the Indian Companies at the time of Foreign Direct Investment,
- (c) Remittance received at the time of allotment of preferential shares by the Indian Companies,
- (d) Investments made by the OCBs in instruments such as FCCB, FRNS etc.

8.48 According to Enforcement Directorate, since the value of inward remittance of OCBs on account of above transactions is not ascertainable, a definite inference regarding inflow—outflow cannot be drawn.

8.49 According to RBI, the total net investments from 1993 till May, 2002 by FIIs and NRIs/OCB under portfolio investment scheme (PIS) are as follows :-

	Net investments US\$Mn.
FIIs	14807.59
NRIs/OCBs*	197.53

\*No separate data is maintained by RBI exclusively for investments by OCBs.

*Year-wise Net Investment by NRIs/OCBs under PIS  
since 1993 is as follows:—*

Year	Net Investment in US Dollar (million)
1993	0.55
1994	56.05
1995	94.55
1996	166.82
1997	121.60
1998	-72.12
1999	0.01
2000	-108.47
2001	-49.28
2002 (upto May 2002)	-12.18
Total	197.53

#### **D. REGULATORY AUTHORITY**

8.50 According to SEBI, OCBs are neither registered nor regulated by SEBI nor are they required to furnish information in respect of transactions to SEBI.

8.51 During oral evidence of RBI, the Committee desired to know who regulated OCBs. A representative of RBI said in reply:

“...It is not under our regulatory framework nor is it under a regulatory framework of a recognized foreign Regulator. ...The moment there is any policy which prescribes the conditions or the framework with reference to which we should regulate or once we know that this is the policy, these are the conditions we should apply, or once we know that policy means no OCB should come into India unless there is Rs.50 crore, or no OCB

should come into India unless NRI owns 51 per cent of total funds or once we have the qualification, requirements, then we will be in a position to immediately prescribe, follow and monitor. That is system background. At the moment there is no framework.”

8.52 The Governor, RBI submitted that, “investigations were conducted and we have found and we accept that many of these OCBs are dummy companies associated with Indian Companies and some of these have resulted because of the nexus between the two.”

8.53 Asked whether at any point of time the question of who should control the OCBs was discussed in the High Level Co-ordination Committee on Financial and Capital Markets (HLCC, FCM) the Governor of RBI in his deposition before the Committee on 12.9.2001 stated as follows:-

“This matter was discussed in the HLCC at the last meeting, and certain conclusions have been arrived at. Now, those conclusions do confirm that OCB is an entity which deserves to be looked at very closely and perhaps that we need to have a tighter control over it.”

8.54 On being asked who monitors the RBI regulations in respect of OCBs, the Governor, Reserve Bank of India stated (8.4.2002) that “the designated bank is supposed to monitor that these guidelines have been followed.”

8.55 When pointed out that the system of monitoring through custodian banks appears to be inadequate, the Governor admitted that “there is a nexus and one or two of the custodian banks did not follow the procedures as strictly as they should have.”

8.56 RBI stated in a written reply that the scope of regulatory framework extends to ensuring that the funds for investment in India are received through normal banking channels and are invested in Indian stock market in accordance with the rules and regulations framed by Securities and Exchange Board of India under whose surveillance stock market functions in India.

8.57 The role of the Reserve Bank as far as monitoring of these investments in concerned is limited to monitoring the aggregate ceilings of overall investments by these investors (24% in case of FIIs and 10% in case of OCBs), as provided in the Portfolio Investment Scheme announced by the Government of India.

8.58 Though monitoring the aggregate ceilings of overall investments by OCBs is the responsibility of RBI, it is observed that RBI could not detect the violations of 10% aggregate ceiling norm by certain OCBs.

8.59 In the normal course, RBI does not conduct inspections of OCB accounts of banks or specifically verify the transactions under Portfolio Investment Scheme (PIS). Inspections of OCB accounts in banks are carried out only on “exceptional” basis in response to any specific information on alleged violation of PIS guidelines.

8.60 In the opinion of the Governor, Reserve Bank is not the appropriate authority for being entrusted with monitoring of flow of funds into stock market from a particular country or jurisdiction.

8.61 In order to prevent undue proliferation of OCBs operating under the PIS without any genuine investment related purpose, RBI has made the following two recommendations for change in the policy relating to OCBs. for consideration by Government:—

- (i) the need to stipulate a minimum paid up capital of Rs.1,00,000 US\$ for OCBs as an eligibility criterion for operating under the Portfolio Investment Scheme. Considering

the cost of employing even one investment manager abroad, this is a small sum and should be easily available to any genuine OCB.

- (ii) the same registration procedure to be followed by OCBs as presently applicable to FIs.

8.62 According to RBI these two additional requirements, if incorporated, would help in keeping away the non-genuine OCBs from the Portfolio Investment Scheme and will not have any adverse impact on inflow of portfolio investment.

8.63 When asked who is responsible for OCBs, the Chairman, SEBI said (13th September, 2001) "Let me say that OCBs are not our babies." Explaining the position regarding SEBI's investigation, the witness stated as under:

"The SEBI investigations (of OCBs) were in the context of price rigging. When we conducted the investigation, there were two situations: one was that the inflow of money from abroad to India and the other was the use of that money in the capital markets.....we found that large amounts of funds came through the route of OCBs and we were not sure these happened to be connected with some of the companies or individuals, which were scamsters. So, in that connection, we looked into it. .... we took up this matter in the high-level committee about OCBs role and there it was discussed. Of course, in confidence, I could also submit that our recommendation was that this route should be closed because this could be a source of drain on the foreign exchange.....Our study and RBI studies show that country has lost money rather than gaining. So the whole purpose of this scheme is lost. What is happening is, some wrong people go and I do not know how these OCBs are set up. So, our view is that if we have to clean up the market, players like these must disappear."

8.64 The Committee received an impression that there had been inadequate regulation in regard to OCBs. Since their persistent query did not yield any specific reply, the Committee directed the representative of the Department of Economic Affairs who was present during the evidence of SEBI on 13.09.01 to find out and report to the Committee by 5.00 PM the next day as to who would be answerable to the Committee about OCB activities. The Ministry of Finance in their response submitted on 10th June, 2002 stated that "clarifications can be given by the Reserve Bank of India on issues arising out of regulations framed by RBI under the provisions of FERA/FEMA".

8.65 The Ministry stated that the matter regarding misuse of the Portfolio Investment Scheme (PIS) was considered by the High Level Coordination Committee on Financial and Capital Markets. The committee took a decision that OCBs shall not be permitted to make fresh investments under PIS. RBI accordingly, notified the decision on 29.11.2001.

## **E. PARTICIPATORY NOTES**

8.66 According to SEBI, four Sub accounts of FIs namely, Coral Reef Investments Co. Ltd. (Sub-account of RP&C International), CAL FP (Mauritius) Ltd. (Sub-account of Credit Agricole Lazard Finance Prod.), DBMG of Mauritius Ltd. (Sub-account of Deutsche International Trust Corpn. CI Ltd.), Kallar Kahar Investment Ltd. (Sub-account of Credit Suisse First Boston) had transacted in scrips associated with Ketan Parekh in a substantial way. Total trading of these sub-accounts was to the tune of Rs.14,000 crore approx. during the period from January 1999 to March 2001. Investigations have shown that entities connected with some of the Sub-Accounts issue Participatory Notes (PNs) as derivative instruments outside India. It is suspected that these instruments enabled entities, which may not be eligible to get registered as FI to transact in

Indian capital market. This instrument enables the holders to hide their identities. Through PNs, various layers are created which make it easier for the holders to keep their identities undisclosed and at the same time purchase shares in Indian market. It is suspected that some of the Indian promoters have purchased shares of their own companies in this way. It appears that shares purchased through this route were shifted to Ketan Parekh entities through OCBs. SEBI has now asked FIs to report about the details of the PNs as and when issued by them.

8.67 Participatory Notes are derivative instruments issued against underlying security of investments in shares. Primarily, the Participatory Notes are one of the methods to raise funds by large investors. An investor wishing to raise resources may collect funds from various investors (retail investors) to pool in the funds against security of underlying investments in shares. Normally, the return of the retail investors are linked to an equity index. PN is issued outside India and represents transaction between two non-residents, who are not subject to the Indian laws. PNs are extra territorial instruments and SEBI has no regulatory jurisdiction over them.

8.68 Asked when SEBI became aware about FIs issuing participatory notes, the Chairman SEBI stated:

“There was some vague idea about this, but they were not under our control. There were no means of knowing it. They are not issued in India. They are extra-territorial documents. We do not have any control over that.”

8.69 When asked about RBI's role in regulating PNs, a representative of RBI stated that there is no such scheme as participatory notes at present and also there is no such provision in the portfolio investment scheme. RBI in a written reply stated that raising of funds by overseas investors through participatory note is not violative of the provisions of FEMA. What is controlled under FEMA is investment in India by eligible entities, such as FIs/OCBs/NRIs. RBI further stated that the method through which such funds are raised abroad (eg. equity, derivative instruments, loans, etc.) by such eligible entities does not come under the purview of FEMA.

8.70 SEBI has stated that it had written to M/s RP&C International, Credit Suisse First Boston (CSFB), Deutsche International Trust Corporation (CI) Limited & Credit Agricole Bank, the Sub Accounts which are under their investigation to find out whether they have issued PNs. Credit Suisse First Boston & Credit Agricole Bank have reportedly admitted that they/their sub-accounts have issued PNs.

8.71 In order to bring more efficiency and transparency in the market, SEBI has since asked FIs to report about details of the PNs as and when issued by them. Asked whether the directive to FIs regarding disclosure of PNs has been enforced, SEBI Chairman stated on 15.02.2002: “Yes Sir. People have started reporting.”

## **F. MAURITIUS ROUTE**

8.72 SEBI's investigations have revealed that OCBs have been operating from various tax havens such as British Virgin Islands, Panama, Isle of Man etc. and Mauritius has been the favourite place for more than 80% of these OCBs which are registered in Mauritius. A large number of OCBs operated from common addresses. Around 60 OCBs shared a particular Post Box Number as address. It appears that these addresses which are shown as registered office of these OCBs are actually belonging to Chartered Accountants which provide financial services to these OCB clients. It is stated that these financial service providers conduct general body meeting over phone in some cases and merely file necessary papers in Mauritius. It is suspected that certain unscrupulous persons residing in India were/are operating behind the facade of these OCBs. It is suspected that some Indian promoters were also using these OCBs as the front.

8.73 SEBI has stated in its Second Interim Report that analysis of the bank accounts of some of the OCBs/Sub-Accounts in India where the sale proceeds were credited showed that large proceeds from these accounts were sent to the accounts of these OCBs/Sub-Accounts with Hongkong and Shanghai Bank in Mauritius. SEBI got in touch with Mauritius Offshore Business Activities Authority (MOBAA) and requested it to provide information as to names of the actual beneficiaries of these OCBs/Sub Accounts, sources of funds which have been used for carrying out transactions and how the funds remitted to Mauritius have been used and to find out whether the net worth of directors/share holders of these companies was enough to carry out transactions of the magnitude noticed during the course of investigations. SEBI wrote to MOBAA with a view to ascertaining the possible role of these OCBs/Sub Accounts in price manipulation in the Indian securities market.

8.74 MOBAA has reportedly informed SEBI that the investigation conducted by SEBI fell outside the ambit of offences which qualify under MOBA Act for "disclosure order" and in view of the confidentiality provisions they were not in a position to provide SEBI with information sought by SEBI about certain OCBs & sub Accounts of FIs.

8.75 The matter was also taken up by the Enforcement Directorate. The Enforcement Directorate has informed in a written reply that enquiries were conducted by deputing a team of officers to Mauritius. Two advance copies of request with regard to the enquiries in respect of First Global Mauritius Ltd. and other 13 OCBs were delivered in the office of the Director, Economic Crime Office at Mauritius on 7.12.2001 after holding several meetings with them. A letter rogatory (LR) in respect of First Global Mauritius Ltd. was issued by Ld. ACMM, New Delhi on 24.12.2001, and a supplementary LR was also issued by the Hon'ble Court on 28.01.2002. The Supreme Court of Mauritius vide order issued in February, 2002 turned down the request made by Hon'ble ACMM, New Delhi. Subsequently, CMM, Esplanade Court, Mumbai has on 21.10.2002 sent fresh Letter Rogatory in the case of First Global Stock Broking Pvt. Ltd. This Letter Rogatory has gone, after complaint has been filed with the Ld. CMM Court. According to the Enforcement Directorate, the chances of making any progress in this case through Mauritius authorities appeared bleak unless reasonable evidence to establish FERA/FEMA violations is discovered here and appropriate proceedings are instituted in India to meet the requirement of Mauritius law.

8.76 SEBI's investigations have brought out several instances of violations by OCBs such as non-delivery of shares, purchase of shares on adjustment basis, booking purchase orders without sufficient balances in their accounts, exceeding the prescribed ceiling of 5 per cent for individual OCBs and violations of 10 per cent aggregate ceiling, etc. Certain OCBs and sub-accounts of FIs also violated the SEBI (Substantial Acquisition of Shares and Take over) Regulations. SEBI has mentioned five OCBs and two sub-accounts of FIs which have aided, assisted and abetted in creation of artificial market and volumes, circular trading and building up concentrated positions in a few scrips. SEBI is reportedly taking action against four OCBs and one sub-account for violation of its regulations regarding substantial acquisition of shares. As regards market manipulations by OCBs, SEBI is stated to be examining the matter legally. The Committee urge that SEBI's remaining investigations as well as its legal examination should be completed expeditiously and appropriate action taken against offenders. The Committee note that the Directorate of Enforcement has also since issued show cause notices to the custodian bank and certain OCBs for FERA violations. The Committee hope that final action in this regard would be completed early.

8.77 SEBI has observed that there had been more outflow than inflow of funds which defeated the very purpose of OCBs' portfolio investments, viz., bringing foreign exchange into the country. According to SEBI, the net outward remittances by 13 OCBs during April 1999 to March 2001 were over Rs. 3850 crore. The Committee, however find that this observation of SEBI is based on incomplete analysis which does not include inflows under non-PIS transactions such as sale of

underlying shares acquired through the ADR/GDR or FCCB route, shares acquired overseas from other NRI/OCBs or through swaps/purchases. The Enforcement Directorate has pointed out that since the inflow figures of corresponding non-PIS transactions of select OCBs are not ascertainable, no definite inference could be drawn as regards inflow-outflow of foreign exchange. Nevertheless, RBI data indicate that net investments during the past 10 years by NRI/OCBs under PIS alone were over 197 million US Dollars. The Committee would, like RBI to undertake a comprehensive analysis of foreign exchange inflows-outflows by OCBs over a period covering both their PIS and non-PIS transactions and come to a conclusion whether this route is profitable or harmful to our economy. The decision about the ban on OCBs should be based on the outcome of this study.

8.78 The Committee do not agree that RBI should leave it entirely to the custodian Banks to monitor compliance of its guidelines regarding OCBs. There is no system of periodical inspection of OCB accounts of Banks by RBI. RBI claimed that its role was limited to monitoring OCB's company-wise investment ceiling of 10 per cent. The Committee note that RBI's monitoring failed to detect violations of even this limited aspect. It is only after SEBI's investigation that violations regarding ceiling norm came to light.

8.79 It transpired during Committee's examination that there has been no regulatory framework to keep an eye on the activities of OCBs. OCBs were neither registered nor regulated by SEBI. The former SEBI Chairman has gone on record saying that OCBs were not SEBI's responsibility. On the other hand, RBI contended that OCBs were not under its regulatory framework. RBI, however, held that if policy framework is laid down by the Government, RBI would be in a position to monitor OCBs. The Committee's persistent query as to which authority is responsible for OCBs has not yielded any specific reply. The Committee note with concern that the Ministry of Finance did not adequately address itself to issues relating to the Mauritius route notwithstanding the growing impact of this Mauritius route on our Capital Market over several years. The Ministry of Finance needs to lay clear policy guidelines about the responsibility to monitor OCBs.

8.80 In the Committee's view, there is a need to have a fresh look at OCBs' operations after an in-depth study of inflows and outflows on a holistic basis covering their PIS and non-PIS transactions. The exercise should also include identification and plugging of loop holes and possible establishment of a proper regulatory set up with stringent penal provisions for violations. The regulatory provisions should inter-alia enable detection of cases where same set of individuals have formed more than one OCB and have their investment spread across the OCBs to escape provisions of SEBI's Take Over Code. The Committee feel that the suggestions made by RBI for stipulation of a minimum paid up capital for OCBs and adoption of same registration procedure as applicable to FIs deserve careful consideration by the Government. The Committee would like the Government to review the ban imposed on OCBs in the light of the above and clearly lay down the responsibility to a particular agency to oversee the OCB operations.

8.81 SEBI has expressed suspicion that some of the Indian promoters have purchased shares of their own companies through Participatory Notes issued by sub-accounts of FIs. This mechanism enables the holders to hide their identities and enables them to transact in Indian Capital Market. The Committee note that SEBI has since directed FIs to report about details of the Participatory Notes as and when issued by them. The Committee suggest that failure on the part of FIs to report about issue of PNs should be viewed seriously and should entail stringent punitive action. It should also be ensured that this instrument is not misused in any way to manipulate the Indian Securities Market.

8.82 SEBI has reported that more than 80 per cent of OCBs are registered in Mauritius and some of them seem to act as front for promoters of certain Indian companies. The Committee note that SEBI's attempt to gather information through Mauritius Offshore Business Activities Authority about the actual beneficiaries of suspected OCBs, their source of funds, their net worth etc. has

not met with success. There are indications of misuse by the OCBs of the provisions regarding Double Taxation Avoidance Agreement between India and Mauritius, through the enactment of MOBAA. This aspect, as in the past, should seriously engage the attention of the Government.

#### G. ROLE OF GOVERNMENT IN THE MAURITIUS ROUTE

8.83 The Double Taxation Avoidance Agreement (DTAA) between India and Mauritius was signed on 24.8.1982 and came into effect in India on 1.4.1983 and in Mauritius on 1.7.1983.

8.84 However, there was little flow of funds into India from Mauritius till the Mauritius Offshore Business Activities Act (MOBAA) was passed in 1992 and the MOBA Authority was established in 1993. This coincided with the policy of economic liberalisation in India which besides Overseas Corporate Bodies (OCBs) and Foreign Institutional Investors (FIIs) were allowed to participate in the capital market in India by way of issuing the guidelines in September, 1992 and by an announcement by the Finance Minister in his Budget speech for financial year 1992-93. Thereafter, some 46 companies incorporated in Mauritius with an asset base in excess of \$4 billion, began investing in India. Since August, 1993, the Income Tax authorities started bringing to the notice of the Government the emerging developments wherein non-Mauritian entities had made substantial investments in the Indian capital market and were availing exemptions from Capital Gain Tax in India under the DTAA by virtue of having obtained resident status from Mauritius under the provisions of MOBAA. By mid-1994, the concerned Income Tax authorities estimated that the investible corpus would be approximately \$1208.5 million and that the potential annual revenue loss to India could be anywhere between Rs.90 crores to Rs.300 crores based on the long-term and short-term tenures respectively of such investments. It was also pointed out that even our public sector concerns were taking to the Mauritius route to avoid tax liabilities in India. Apprehensions were expressed that the inflow of investment from Mauritius into India might substantially comprise monies taken out from India clandestinely to Mauritius for reinvestment in India with the objective of avoiding tax liabilities in our country by enjoying the DTAA exemptions.

8.85 During the period 1993-96, the following steps were taken by the Government of India and its agencies to address growing Indian concerns:

- The Chief Commissioner Income Tax-II, Bombay intimated in August 1993 that "huge investments" are taking place "in the secondary market by foreign financial institutions." The India-Mauritius DTAA, it was said, was being misused to give parties non resident in Mauritius the full benefits of the DTAA (applicable only to bona fide Mauritius residents) by nominee companies in Mauritius undertaking investments on behalf of clients not resident in Mauritius.
- Apparently without first exploring the possibility of resolving the "difficulties" and "doubts" under the provision Section (3) of Article 25 of the DTAA. Section (3) of Article 25 provided that "The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention." This was inspite of the fact that following a meeting on 23.11.1993 at Nagpur between the Prime Ministers of India and Mauritius the latter had handed over a Memo on issues of bilateral interest, including the DTAA, mentioning *inter alia* that "... in order to prevent misuse of the Treaty, Mauritius has already indicated its willingness to set up regular revenue intelligence sharing with India."
- There followed correspondence and discussion between MEA and MoF commencing with a letter dated 12.4.1995 written by Shri Sivaraman, Secretary(R) requesting the

then Foreign Secretary Salman Haider to take appropriate actions to serve the requisite notice on Mauritius Government by 30.6.95 to invoke Article 29 for re-negotiation of the DTAA. However, MEA ignored the request allegedly in view of its opinion that the issues might be discussed during the proposed visit of Mauritian FM to India during 23-26.8.1995.

- The Government issued a Circular No.682 dated 30.3.1994, confirming Mauritius resident status under the DTAA to all those companies whom Mauritius had granted resident status, irrespective of their real state of origin, as a clarification to the points being raised by the Income Tax authorities relating to their eligibility to tax exemption under the DTAA, the issue was studied in detail over a period of about a year in the Finance Ministry commencing from the observation made by Shri P.J. Nayak, Joint Secretary (ECB & Investment) in his note dated 3.11.1993 to the Finance Secretary that "...the present tax benefit related 'leakages' are unintended consequence of the Convention (with Mauritius) which was signed several years back" and then submitted to Finance Secretary Montek Singh Ahluwalia who, in turn, recorded his observation to the FM that "many FIs have set up Asset Management Companies in Mauritius as vehicles for investment in India to benefit from the concessional tax treatment available to 'residents' of Mauritius where the tax applicable is the lower of the convention rates or the Mauritian rate. Since the capital gains tax in Mauritius is Zero, AMCs set up in Mauritius attract zero tax. ....we entered into the convention for double tax avoidance in 1983 without considering the extent to which it would allow a window of preferential treatment which could be used by a wider set of entities than we envisaged. But, if this is so we should try to abrogate the treaty."
- The issue was studied in detail and then submitted to Finance Secretary Dr. Montek Singh Ahluwalia who recorded on 19.07.94 that "The Mauritius window is clearly an aberration arising out of history.... The present situation is anomalous."
- Subsequently, on 11.08.94, FS recorded that he "had not realized that there are 12 countries with which our DTAA allows complete exemption from capital gains" and directed that "We should certainly review the position."
- Following the review, FS recorded on 7.12.94 that "we cannot justify a separate tax treatment for FIs coming via Mauritius when we have ourselves specified a general treatment of all FIs which is less favourable." He, therefore, agreed (the last line of p.38-N has been torn so it cannot be quoted exactly) that we should close the Mauritius window "if we can".
- After taking a meeting on 13.1.95 the file was seen by Finance Minister Dr. Manmohan Singh on 1.2.95 when he was informed that Secretary (Revenue) had written to Foreign Secretary seeking a re-negotiation of the DTAA.
- On receiving the reaction of the Mauritian authorities to the renegotiations proposal, the file was once again submitted to FM by Revenue Secretary on 14.3.95 pointing to "Mauritius becoming a tax haven for fly by night operators with hot money to come into the Indian capital market." He added, "Indian companies are also reported to be using it as a base now." FM called for a discussion on Revenue Secretary's proposal that Mauritius should be pressed to "agree for a dialogue on this matter" and that: "We need not precipitate matters now."
- Then, on 5.4.95, Joint Secretary (FT&TR) recorded that "FM discussed the issues raised in Secretary (R)'s note on 3.4.1995 with Secretary (R) and Chairman, CBDT.....FM directed that we should proceed to give notice to the Government of Mauritius through diplomatic channels for renegotiating the Double Taxation Avoidance Agreement."

- There followed correspondence and discussions between MEA and MoF, on the one hand, as also reports from High Commissioner, Port Louis about Mauritian reactions to the Indian moves. Indian High Commission in Port Louis expressed apprehensions about adverse fall out against any move, if initiated by India, for re-negotiation of DTAA which might lead to diversion of investments from Mauritius to other destinations etc. In the wake of these developments, a detailed status note was put up to FM who made two comments: one, that “We should get the full facts” about the Mauritius proposal to levy a tax of 15% (which eventually turned out to be applicable only to profits and not capital gains) and, two, “We should act with the full knowledge and support of MEA in this matter.”
- On 26.7.1995, Secretary Revenue called on the Indian High Commissioner in Port Louis and, according to a dispatch from the High Commissioner to the Ministry of External Affairs dated 4.8.1995, proposed “re-negotiating the Treaty and plugging the exiting loophole” for the following five reasons:
  - \* “Virtually all foreign investment projects were being routed through that country (Mauritius)”
  - \* “A number of Indian companies were also setting up entities in Mauritius....solely to avoid paying taxes”
  - \* “Evidence of large scale laundering of money through Mauritius”
  - \* “This may include drug-related money”
  - \* “The potential revenue loss was substantial and would increase to large proportions in future.”
- The High Commissioner had his reservations about the course of action proposed but recommended that this sensitive issue be discussed with the Finance Secretary and the Finance Minister of Mauritius when they transited through New Delhi on their way to Moscow a few weeks later.
- In consequence, the Finance Minister of Mauritius arrived in Delhi en route Moscow and took the initiative in asking for a call on FM. This was preceded by a meeting of officials at which the Minutes were formally prepared and signed by both sides on 22/8/95. The two FMs then met the following day. A press release was issued with the approval of both Ministers constituting a Joint Working Group to take up outstanding issues.

8.86 The Joint Working Group (JWG) met in Port Louis from 16–20.12.1996. The Indian delegation proposed amendments to several articles of the DTAA and also suggested the insertion of three new Articles in the Agreement relating to :

- “Fees for Technical Services”
- “Collection Assistance”
- “Limitation”, that is:

“If, in accordance with the provisions of this Agreement, the right of India to tax income is limited and according to Mauritius tax laws the income is regarded as income from foreign sources and therefore exempted from Mauritius tax, India may tax such income as if this Agreement did not exist.”

8.87 Mauritius did not accept these amendments but it was agreed that the MOBA Authority would not register any India-based companies or other entity which applies for registration and brings funds originating from India for re-investment to India and, where registration has already been granted, the same shall be revoked by the said authority under the provisions of the MOBA Act, 1992". At its meeting in February 1997, the India-Mauritius Joint Commission endorsed this decision.

8.88 In consequence, the Mauritius authorities proposed an exchange of notes at government level to give effect to the understanding reached. The High Commission of India's communication dated 25.4.1997 indicates that the Mauritian authorities agreed to the draft text proposed to them by the Government of India and proposed that the draft be converted into an exchange of letters in Port Louis between the High Commissioner of India and Mauritian Ministry of Foreign Affairs.

8.89 However, when the Government of India failed to authorize the exchange of letters, the MOBA Authority went ahead on its own to incorporate the understanding "as one of the conditions governing grant of an Off-shore certificate" (communication from First Secretary, HCl, Port Louis to Joint Secretary (FT & TR) Ministry of Finance, dated 11.9.1997)

8.90 Notwithstanding this unilateral action by the MOBA Authority, CBDT continued await Ministry of Law's clearance to the exchange of notes at government level. This was referred back to MOF for reconsideration—on 14.7.1998—as the Ministry of Law observed that MOBAA "revocation of certification would be subject to judicial scrutiny."

8.91 Thereafter, the Mauritius Finance Minister visited India in September 1998 and called on the Finance Minister, Shri Yashwant Sinha on 24/9/98. The minutes of the meeting state as follows:

"It was pointed out that several companies of India origin register in Mauritius to avoid domestic taxes and take benefits under Indo-Mauritius Avoidance of Double Taxation Treaty. The Finance Minister of India indicated that there is need to address this issues so that companies do not misuse the special status India has with Mauritius to avoid domestic tax incidence. The Finance Minister of Mauritius clarified that as per the Mauritius law there should not be any difficulty in de-registering such companies."

Following his meeting with the Mauritian Finance Minister, the Indian Finance Minister recorded on file that he had been informed by the Mauritian FM that "there would be no difficulty in excluding from the list companies which should not be allowed to take advantage of the Offshore Business Activities Act, 1992. They are prepared to move further in the matter. Further action may be taken in the light of the clarification given by the Finance Minister of Mauritius."

8.92 However, no precise criteria were laid down for categorizing companies "not allowed to take advantage of MOBAA; no companies of concern to India were actually taken off any list; numerous other companies were added to the list; and no list of companies for deletion from the list was forwarded to Mauritius moved further in this matter, nor did the Government of India press them to do so.

8.93 The Deputy High Commissioner, Port Louis in her message to the Ministry of External Affairs dated 3.12.01 has stated that:

"No interaction took place specifically on the DTAA during 1999 and 2000, except for the exchange of letters of 27.3.2000 from the Finance Minister of Mauritius and our reply thereto."

Moreover, the same message from the Deputy High Commissioner indicates that:

- During the transit visit of the Indian Finance Minister to Mauritius on 14.11.1999, "there is nothing on our records to indicate that matters pertaining to the DTAA were discussed during the meeting".
- Nor were DTAA issues discussed when the Finance Minister of Mauritius visited India for over a week from 24.2.2000 to 4.3.2000.

Furthermore, DTAA matters do not appear to have been discussed when the Indian Prime Minister visited Mauritius in September 1998 and March 2000 nor when the Mauritius Prime Minister was in India in October 1998. The External Affairs Minister has confirmed to the Committee that when his counterpart called on him in New Delhi in January 2001, DTAA-related matters were not discussed.

8.94 The Committee has also been informed that after the first meeting of JWG in December 1996, no further meetings of the JWG have been held. The India-Mauritius Joint Commission has also not met since 1997.

8.95 The only interaction of note between India and Mauritius on DTAA-related matters between September 1998 and the constitution of this Committee in May 2001 is a letter from the Mauritius Finance Minister dated 27.3.2000, forwarded by the High Commission direct to the Finance Minister of India on 28.3.2000, and the reply from the Finance Minister of India to the Mauritius Finance Minister dated 13.5.2000. In his forwarding letter, the High Commissioner stated that when the Mauritius Finance Minister called HC to his office on 28 March, the Mauritius FM had said:

"In case there are any Indian concerns of recent origin, these can be addressed through discussions between officials from both sides."

The Indian Finance Minister's reply of 19.5.2000 does not refer to the Mauritius offer to hold such discussions. No discussions were held till mid-2002.

8.96 Finally, in July, 2002, an understanding was reached that where the place of effective management of an Indian company was in India, the company would be liable to tax in India under the terms of the tie-breaker clause of the Treaty. The Mauritius Government has since amended its laws to allow Exchange of Information under the treaty obligations. Assurance was given by the Mauritius side that full cooperation and information will be provided to the Indian tax authority to resolve cases of misuse of the treaty or unintended benefits.

**8.97 The Committee regret that although Indian concerns about the Mauritius route had been formulated soon after the establishment of MOBAA resulted in substantial financial inflows into India, including money laundering by Indian companies making illegitimate use of the Mauritius route, once the India-Mauritius Joint Commission in February 1997 had endorsed the JWG decision of December 1996, virtually no action was taken to raise and pursue these concerns with the Mauritius authorities although foreign financial inflows into India from Mauritius rose to over Rs.15000 crore, constituting nearly a third of all foreign investment in the country. The Committee are particularly disturbed to note that notwithstanding FM's instructions to his Ministry officials after his meeting with the Mauritius Minister in September 1998, and the offer made to the Indian Finance Minister by the Mauritius Minister in March 2000 to address Indian concerns of recent origin, little or nothing was done in the Ministry or by the Minister to raise these issues with Mauritius. The Committee are of the view that although the inflow from Mauritius was, in principle, welcome, due care also needed to be exercised about possible misuse of this route. Instances of such misuse have come to light and misuse of the route appears to have been significantly responsible for market manipulations during the boom of 1999-2000 which led to the bust of 2001. The Committee commend the steps taken in July 2002 to amend the DTAA. Continued vigilance on this front will be necessary to prevent scams of the kind that occurred in 1999-2001 when due attention was not being paid to the dangers inherent in the virtually unregulated Mauritius route.**

## CHAPTER IX

### SECURITIES AND EXCHANGE BOARD OF INDIA

9.1 The Securities and Exchange Board of India (SEBI) is the primary regulator of the securities market. SEBI was constituted in 1988. Through an Act of Parliament, it became a statutory body only in 1992. Since then, the Securities Exchange Board of India Act, 1992 (Act of 1992) has undergone several amendments, being the Securities Laws (Amendment) Act, 1995 (Act 9 of 1995), the Securities Law (Amendment) Act, 1999 (Act 31 of 1999) and the Securities Law (Second Amendment) Act of 1999 (Act 32 of 1999). The coming into force of the Act of 1992 brought to an end the regime under the Capital Issues (Control) Act, 1947. Under Section 31 of the Act of 1992, rules and regulations framed to give effect to the provisions of the Act are required to be laid before Parliament. Multifarious rules, regulations and guidelines have been framed by SEBI from time to time to meet with contingencies arising in the course of dealings in the capital market. These regulations, rules and guidelines cover a wide range of issues.

9.2 The emerging capital market, pursuant to the liberalisation of the economy, required SEBI to be a hands-on statutory body constantly monitoring the securities market and issuing appropriate guidelines from time to time. This became all the more necessary with the increasing role of foreign institutional investors in the securities market. Guidelines were also set in place to deal with the activities of foreign brokers in the Indian stock exchanges, on behalf of registered foreign institutional investors. For this purpose, regulations and guidelines for foreign institutional investors were framed. Regulations were also framed for the depository participants and depositories in the stock market, the role of future capital funds, mutual funds, guidelines for participation in stock lending schemes, guidelines for mutual funds, Regulations relating to Substantial Acquisition of Shares and Take Over (1997), Regulations relating to Buyback Securities (1998) and Regulations relating to Credit Rating Agencies (1999). References to these regulations, rules and guidelines are not exhaustive but are only illustrative to indicate the complexity of the issues arising from the opening up of the capital market.

9.3 SEBI is a regulator also of the stock exchanges and all the brokers who operate the stock exchanges. Under Section 11 of the Act of 1992, SEBI is charged with the responsibility of regulating mutual funds, other persons associated with the securities market, all intermediaries and self-regulatory organizations in the securities market. SEBI is also to regulate the work of depository participants, FIs, Credit Rating Agencies and other intermediaries. Its most significant role is the regulation of stock brokers, sub-brokers, share transfer agents. Reference to this, again, is not exhaustive. The ultimate responsibility of the regulator—SEBI—is to protect the interests of investors in securities and to promote the development of the securities market and, of course, its regulation.

9.4 The capital market is a relatively recent phenomenon in India. The breadth of the capital market has increased many-fold after the liberalization of the economy. One would have thought that as a regulator, which had substantial powers under the Act of 1992, SEBI would have been ever vigilant to deal with any contingencies that may arise out of manipulations of the stock

market by brokers, promoters, banks, corporate entities, FII's and other equally significant players. This was all the more necessary because of the 1992 scam which brought to the fore the manner in which unscrupulous brokers used mechanisms in the securities market for personal aggrandizement.

9.5 Any analysis of the volatility in the securities market from 1.9.1999 to 30.3.2001 would be incomplete unless the role of various contributories is enquired into. The brokers represent the institutional mechanism through which actual trading takes place. Brokers work in most cases for brokerage except when they operate themselves as investors in the market. The other contributories are corporate houses who invest in particular shares in the market through brokers in the light of their respective perceptions as to the value of the shares of the company being traded in the securities market. Financial institutions, the FII's and other large players in the market, including the UTI played a very significant role during the period from 1.9.1999 to 30.3.2001. The role of depositories is also significant. The role of stock exchanges, of which the various brokers are members, is to ensure that the brokers conduct themselves in a manner consistent with the law, regulations, rules and the guidelines framed by SEBI from time to time; and in the event, they are suspicious of the conduct of a particular stock broker, to enquire into that conduct, deal with it and/or refer the matter to SEBI for investigation and appropriate action. With the emerging role of foreign institutional investors, SEBI was also required as a regulator to delineate their role to ensure that they, too, function within the framework of the law. The Mauritius route and in that context the use of Overseas Corporate Bodies (OCBs) and the issuance of participatory notes by FIIs, all contributed to the manipulations in the securities market.

9.6 SEBI, as a regulator, was aware of the fact that though the Indian stock market is broad-based in purely numerical terms, it does not reflect broad-based participation in relation to volumes of all scrips traded in the market, during the period when the market reached its pinnacle before ultimately crashing after March 2001. The phenomenal rise of the securities market and the enormous trading volumes in certain specific scrips referred to as "K-10 stocks" (Aftak Infosys, DSQ Software, HFCL, Global Tele-system, Pentamedia Graphics Ltd., Ranbaxy Laboratories, Silverline Technologies, Satyam Computers Ltd., SSI Ltd. and Zee Telefilm Ltd.) was a phenomenon peculiar to the Indian securities market. Occasionally, almost sixty percent of the entire trading in stock exchanges related to those specific scrips. To that extent, the participation in the market was not broad-based.

9.7 Resource mobilization from domestic issues in the primary market from the year 1993-94 was as follows:—

	(Rs. in Crore)								
	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
Public issues, etc.	29,578	30,800	22,832	18,806	7,639	9,365	7,704	6,363	7,111
Private placement	7,466	11,174	13,361	15,066	30,009	49,679	61,259	67,836	64,950
Total (domestic issues)	37,044	41,974	36,193	33,872	37,738	59,044	68,963	74,199	72,061

The turn over in secondary market during each of the years since 1993-94 was as shown below:—

Year	Turn over (Rs. in Crore)
1993-94	203,703
1994-95	162,905
1995-96	227,368
1996-97	646,116
1997-98	908,681
1998-99	1,023,382
1999-00	2,067,031
2000-01	2,880,990
2001-02	895,826

9.8 It may be observed from the above data that in the primary market while mobilization of funds through public issues has been sharply declining year after year since 1993-94, mobilisation of funds through private placement has been steeply going up. Similarly, the turnover in the secondary market which was sharply going up every year after 1994-95 registered a steep fall in the year 2001-02. It may be seen that as compared to the boom in secondary market till 2000-01, the mobilization of capital in primary market through public issues has drastically fallen over the years since 1994-95.

9.9 SEBI should have been alarmed by situations where the development of the primary market did not match with the Secondary Market. The scam that this Committee are dealing with relates to the artificial manipulations of prices of certain heavily traded scrips by brokers with the help of other players in the market resulting in a perception which enticed innocent ordinary investors to further invest in the market resulting in increased trading activity. It is when the market is manipulated in this manner that the prime regulator, namely SEBI is required to be even more vigilant. Those deposing before the Committee have opined that the rise and fall of share prices cannot be termed as a 'scam'. It is the financial mechanism used by different players in the market contributing to its artificial rise that represents the scam. This involves brokers, Urban Cooperative banks, Private Banks, Stock Exchanges, Depositories, corporate entities, financial institutions, FIIs and the UTI.

9.10 The Committee's examination of SEBI in the context of the Stock Market Scam is discussed in the following sections.

## 1. REGULATION OF BUSINESS IN STOCK EXCHANGES

### A. Inspection

9.11 As a part of regulation of business in the stock exchanges, SEBI has been inspecting the stock exchanges once in a year since 1995-96. SEBI inspects only those exchanges which have active trading. During these inspections, a review of the market operations, organizational structure and administrative control of the exchange is made to ascertain whether :

- (i) the exchange provides a fair, equitable and growing market to investors;

- (ii) the exchange's organization, systems and practices are in accordance with the Securities Contracts (Regulation) Act, 1956 and rules framed thereunder;
- (iii) the exchange has implemented the directions, guidelines and instructions issued by the SEBI from time to time; and
- (iv) the exchange has complied with the conditions, if any, imposed on it at the time of renewal/grant of its recognition under section 4 of the SC(R) Act, 1956.

9.12 Based on the observations/suggestions made in the inspection reports, the exchanges are advised to send a compliance report to the SEBI within one month of the receipt of the inspection report by the exchange and thereafter quarterly reports indicating the progress made by them in implementing the suggestions contained in the inspection report. The functioning of the exchanges are also being monitored through a Monthly Development Report which the exchanges are required to submit to the SEBI every month. However, it has been noticed that the quality of Inspection by SEBI has been poor and there is a need for improving and standardizing the format of monthly reports furnished by Exchanges.

9.13 Besides this, SEBI also reportedly monitors and follows up the rectification of the deficiencies and violations pointed out in the inspection reports through both, off-site and on-site mechanisms. These include, discussions with administration of the stock exchanges, periodic reporting requirement by the exchanges after placing the periodic reports before the governing bodies, discussions in the governing body meetings, and verification of the extent of compliance with the findings of the inspection reports during the subsequent inspection.

9.14 SEBI analyses the compliance reports and advises the stock exchanges if there is inadequate rectification of the deficiencies or if the suggestions are not implemented. The findings of the report and their compliance are required to be discussed also at the meetings of the Governing Boards of the stock exchanges. SEBI's own officials who are nominee directors in 13 exchanges also take up the compliance issue in the board meetings when the compliance reports are discussed.

9.15 SEBI's inspection reports on CSE for three years were obtained by the Committee. These reports relate to September, 1998, October, 1999 and September, 2000 and had brought out numerous violations/deficiencies on the working of CSE. The Committee noted that some deficiencies found repeated mention. Some of the inspection observations regarding deficiencies which were repeated in all the three years are illustrated below :—

- (i) The Exchange shall reduce the post settlement period by one day and comply with SEBI Circular dated 13/8/1996 which require the Exchange to complete the settlement within 7 days.
- (ii) The Exchange should ensure that the close out in case of short deliveries pertaining to the settlement should be in accordance with SEBI Circular dated 9.12.1996.
- (iii) The Exchange is advised to take stern action such as suspension of membership, de-activation of trading terminals, imposition of fine/penalty against the members, depending upon the nature of violations so that it acts as a deterrent for them to repeat such violations in future.
- (iv) The Exchange should empower the officials of the Exchange at various levels to take the required operational decisions promptly without the approval of the President or Executive Director regarding de-activation of the trading terminals of the members.

- (v) The Exchange should immediately streamline the system of reporting and recording of all the off-the floor transactions. The Exchange should ensure that off-the floor transactions are considered for intra-day trading limit and margins are also collected promptly.
- (vi) The Exchange should not adjust the amount deposited by the members towards additional capital against the margin liability.
- (vii) The Exchange should ensure that the margins are collected before the commencement of trading on the following day by directly debiting the margin liability to the member's bank account.
- (viii) The manual entry system of margin due from brokers should be done away with and automatic downloading from the system should be introduced.
- (ix) The Securities Department and Surveillance Department should be linked on-line so that any change in BMC of the member is automatically updated in the margin statement of the Surveillance Department.

9.16 SEBI's special inspection conducted in May, 2001, attributed most of the above deficiencies as having contributed to the payment crisis of CSE in March, 2001.

9.17 Pointing out from the inspection reports that there were failures of CSE which found a mention, time and again, in the inspection reports, the Committee desired to know what SEBI did to remove those problems. In response, a representative of SEBI said during evidence, "We do the follow up by calling for some compliance reports from the exchange. The compliance reports which we have been receiving from the exchange showed that whatever irregularities have been pointed out have been complied with (rectified). We found in the subsequent inspections again, there were certain irregularities of that nature. These things were regularly being taken up." The witness mentioned in this connection that over a period of time there has been a general improvement in the level of compliance against the findings of each year's inspection report.

9.18 Pointing out the observation made in SEBI's inspection report for the year 1999-2000, that the Exchange should not adjust the amount deposited by the members towards additional capital against the margin liability a representative of SEBI mentioned that CSE had confirmed in the compliance report that this would be complied with. The witness added that "When we did the special inspection in March, 2001, we found that this was not complied with".

9.19 SEBI conducted annual inspection of CSE in October 1999 and September, 2000. SEBI's official nominee director said in this context that in the year 2000, inspections were carried out at the Calcutta Stock Exchange and the fact that the margins were not being collected as per the circular did not get reflected in the inspection. Asked whose fault was it that, the SEBI's inspection did not reveal the non-compliance, the witness said : "I feel that what we really need to do is to get system's audit".

9.20 The number of brokers inspected by SEBI was 157 in 1997-98, 103 during the year 1998-99 and 80 during 1999-2000. Asked about the reasons for the number of inspections of brokers coming down over the years, the Chairman, SEBI attributed it to inadequacy of staff and said "we did not do it. Let me be honest with you".

## **B. Responsibilities of nominee directors**

9.21 Rule 10 of Securities Contracts (Regulation) Rules, 1957 provides that SEBI may nominate one or more persons not exceeding three in number, as members of the governing body of

every recognized stock exchange. Accordingly, SEBI is nominating three nominee directors on the Boards of the recognized stock exchanges. Out of these three nominees, generally, one is the SEBI official, one is the representative of Department of Company Affairs and one represents the State Government of the area where the stock exchange is located. The SEBI nominee directors and public representatives on the governing board/council of management of the stock exchanges are required to pursue implementation of inspection suggestions in the meetings of the governing board/council of management.

9.22 The SEBI's official appointed as nominee director is required to report to SEBI on the important matters discussed in the Board with particular reference to the following:—

- (i) Implementation of suggestions/recommendations given in the latest Inspection Report of SEBI.
- (ii) Action taken by the Exchange to implement the directions given by SEBI through circulars from time to time.
- (iii) Functioning of Surveillance Department.

9.23 SEBI's instruction of 2.7.1999 requiring the Exchanges to include the long position crystallised at the end of the previous settlement in the outstanding position of the brokers for the purpose of exposure limit and margins was not implemented by the CSE. A representative of SEBI stated categorically that had this instruction been implemented by the CSE, the payment problem which arose in settlement Nos. 148 and 149 would have certainly been avoided. Enquired whether compliance of SEBI circulars regarding particular cases would come before the governing Board, SEBI's official nominee director in CSE said during evidence, "What we would get on the agenda is not specific cases. We would get information whether the circulars are being followed, are the margins being collected, are they de-activating the terminals etc. Such kind of information would come before us. We would not be discussing specific cases." The witness added that agenda items are brought up before the Board by the Executive Director.

9.24 An analysis of attendance record of nominee directors of SEBI in the Governing Board meetings of Stock exchanges, from the years 1992 to 2002 indicates that attendance record leaves much to be desired. In BSE, in 16 out of 36 cases, the percentage of attendance during the aforesaid period has been less than 50%. The maximum attendance recorded was 95% and the minimum 11%. In so far as CSE is concerned, in 11 out of 33 cases attendance has been less than 50%. There were two cases in which attendance was zero. In one case the nominee did not attend even a single sitting out of 53 sittings held during his tenure from October 1991 to April 1993. In another case the nominee did not attend any sitting out of 29 sittings held during his tenure from November 1996 to June 1998. As regards NSE, in 2 out of 15 cases the attendance has been less than 50%.

9.25 The JPC which enquired into Irregularities in Securities and Banking Transactions (1993) in their Report had expressed concern over low level of attendance of Government nominees in the meetings of Governing Boards of Stock Exchanges and had observed that such nominees have contributed precious little in arresting the various malpractices in stock exchanges. The Committee held that the need for having such Government nominees on the Stock Exchanges needed to be reviewed with the constitution and transfer of regulatory power to SEBI. In pursuance of this recommendation the Government have amended Rule 10 of the Securities Contracts (Regulations) Rules, 1957. SEBI is now empowered to nominate three persons of its choice in the Governing Bodies of Stock Exchanges. It was expected that such a system would strengthen the regulatory powers of SEBI and also enable SEBI to exercise greater supervision of the affairs of the Governing Boards of every recognized Stock Exchange.

9.26 SEBI has observed from a study of international patterns of corporatisation and demutualization that regulatory bodies are not represented on the boards of any demutualised stock exchange. SEBI has stated that the Government had also recommended that market regulator should not appoint its officials on the Governing Board of the Stock Exchanges to avoid conflict of interest situations. The practice of nominating SEBI officials on the Governing Board of Stock Exchanges has since been discontinued from 28/12/2001. Presently no SEBI official is represented on the Governing Board/Board of Directors of any Stock Exchanges.

9.27 Despite the elaborate procedure set out by SEBI for inspection of Stock Exchanges and for taking follow-up action thereon, it had not been able to ensure compliance of its recommendations within a time frame. As a result, the numerous violations/deficiencies brought out in the inspection report of the year 1998 found repeated mention in the inspection reports of 1999 and 2000 and still remained unrectified. Ultimately, these very factors are found to have contributed to the payment crisis of CSE. The Committee fail to understand why SEBI had not thought it necessary to take punitive action in the event of non-compliance of its inspection recommendations within a time frame. The Committee desire that SEBI must evolve an effective system of compliance with inspection findings.

9.28 The Committee note that SEBI's quality of inspection of October, 1999 and September, 2000 was so poor that it could not detect CSE's non-inclusion of crystallised long positions in the outstanding position of brokers although this was clearly violative of SEBI's instruction of July, 1999. The Committee feel that this shortcoming in SEBI's inspection is all the more serious if viewed in the light of SEBI's categorical assertion that had CSE implemented SEBI's instruction, the payment problem would have certainly been avoided.

9.29 The Committee learn that due to inadequacy of staff, the number of inspection of brokers carried out by SEBI has been gradually coming down from 157 in the year 1997-98 to 103 in 1998-99 and to 80 in 1999-2000. This is not a satisfactory situation and reflects poorly on SEBI. Checking irregularities and malpractices of stock brokers is one of the primary functions of SEBI which could be achieved through the solid instrument of inspection. The Committee urge that SEBI should augment its staff strength, if need be, and progressively increase its coverage of inspection of brokers.

9.30 The performance of SEBI's nominee Directors in discharge of their role is anything but desirable. The attendance record of some of SEBI's nominee Directors in the governing board meetings has also been very poor in as much as one nominee Director in CSE did not attend even a single sitting out of 53 sittings during his tenure from October 1991 to April 1993 and another did not attend any sitting out of 26 sittings during his tenure from November 1996 to June 1998. The Committee note that SEBI has since discontinued the practice of nominating SEBI officials on the governing board of exchanges. The Committee urge upon SEBI to henceforth strengthen its in-house systems and infrastructure and make optimum use of modern technology for carrying out focussed inspection of all aspects of functioning of stock exchanges and follow-up vigorously redressal of shortcomings and deficiencies found out in the inspection reports.

9.31 The Committee recommend the following :—

- (i) The role of Executive Directors in charge of the Secondary Market Division and the Surveillance Division in SEBI during 1999 and 2000 needs to be critically looked into for not ensuring compliance with various actions recommended in the inspection reports of 1999 and 2000.
- (ii) Explanation be called for immediately from all concerned officials in SEBI who were involved in the task of inspection of CSE during 1999 and 2000 regarding their failure

to detect non-inclusion of crystallised long position in the outstanding position of the brokers and action be taken for dereliction of duty.

- (iii) The poor attendance of SEBI nominee directors in the Board meetings of Stock Exchanges in the past puts a question mark on the efficacy of the system of nominee directors. Although SEBI has since discontinued the system, the Committee desire that the Ministry of Finance should undertake a fresh review of the system of nominee directors keeping in view the proposed demutualisation and corporatisation of stock exchanges.

## 2. SURVEILLANCE AND INVESTIGATION

9.32 Market Surveillance plays a key role in ensuring safety and integrity of the markets. It also ensures effectiveness and efficiency of a regulatory system. Market Surveillance Division was set up in SEBI in July, 1995 with a view to effectively monitor abnormal market activities and detect market manipulation. It was involved in monitoring market movements, identifying price volatility, analysing its causes and overseeing surveillance activities of the stock exchanges. The division since its inception organized itself to carry out its responsibility of protecting investors and ensuring a healthy development of the security markets.

9.33 The primary responsibility of stock market surveillance is with the stock exchanges themselves. In SEBI's view exchanges are the first level regulators and the primary responsibility of monitoring and surveillance lies with them. SEBI keeps a proactive oversight on market monitoring and in exceptional circumstances it analyses the same. When appropriate, on the basis of reports received from the stock exchanges or specific complaints, preliminary enquiries are conducted to determine whether the trading raises suspicion of market manipulation and/or insider dealing. Matters are also taken up suo-motu. In case an analysis of the trading information for the stock exchanges leads to a suspicion of market abuse, then, client details and records are obtained from the stockbrokers. If further analysis of these records suggests the possibility of occurrence of market manipulation or insider dealing or other misconduct, investigations are initiated. SEBI has stated that its market surveillance and monitoring functioning has thus been focused on :—

- (i) supervising and overseeing the surveillance and monitoring activities of the stock exchanges.
- (ii) Policy formulation for introduction of surveillance systems and various measures to enhance safety and integrity of markets.

9.34 Asked why the responsibility of surveillance has been shifted to the stock exchanges contrary to the stated position of SEBI at the time of inception of its surveillance division, a representative of SEBI stated as under :—

“Initially the Exchanges did not have anything (regarding surveillance) and it was new to them. Later on, stock-watch system was established in the Exchanges and keeping with the world-over trends, the self-regulatory organizations have to take up that responsibility, our attempt was to make them more responsible, primarily responsible and to increase our oversight activity. With that policy shift, that the role of SRO has to be more effective and pro-active, we tried to make them more responsible in the area of surveillance while keeping some sort of oversight at the stage of SEBI. So, that policy shift was brought consciously to make the Exchanges focal point of market monitoring and surveillance activity.”

9.35 The Chairman, SEBI stated in this regard as follows :—

“Trading takes place at the Stock Exchange level. The players are at the Stock Exchange level.... We are the regulatory body.... We are regulating them.... with three crore investors, 10,000 brokers and 10,000 companies, obviously SEBI cannot be a super exchange. It is a regulator. So, we would only have an oversight. In specific cases, we have the power. We can look into those and we have looked into those”.

The witness also said in this context :

“Today I was checking with SEC, which is the most renowned regulator of the world, the toughest regulator of the world. They do not have surveillance. They leave it entirely to the Exchange. I am not saying that we would do it.”

9.36 Intricacies and complexities involved in Market Surveillance are stated to be as under:—

- Indian capital markets comprise of 23 exchanges, of which around 10 exchanges have active trading and 5 exchanges have large trading volumes.
- There are more than 9800 listed companies having multiple listings across many exchanges. In addition to multiple listings, many exchanges admit scrips as permitted securities for trading without listing.
- There are more than 10000 registered brokers and about 10,000 sub-brokers. Many brokers have multiple memberships across different exchanges.
- Around 10 lakh transactions take place daily on the exchanges peaking to around 20 lakh on occasions.
- Investors are spread out over a large geographical area, with online trading terminals available in more than 500 cities/towns. There is no system for allocation of unique IDs to Indian citizens which also makes identification of ultimate clients difficult.
- There are more than 500 registered FIs with more than 1300 registered sub-accounts. In addition corporate players include a very large number of private limited companies, limited companies, Overseas Corporate Bodies, Indian financial institutions, banks and mutual funds.
- Different exchanges follow different settlement cycles.

9.37 SEBI has stated that voluminous trading related data generated at various exchanges, are accessible only within each exchange. Exchanges now have online monitoring systems capable of handling this data, and SEBI has endeavoured to ensure that exchanges are equipped both technically and in terms of manpower to conduct monitoring and analysis of the same.

9.38 To have more effective system of market surveillance keeping in line with the international standards, Stock Watch System has been developed at the level of the stock exchanges under the initiative and management of SEBI. According to SEBI's Annual Report of 2000-01, major exchanges have implemented the real-time alert generation systems at a basic level. However, as the hardware and software is vendor supplied and is different in different exchanges, the implementation differs from exchange to exchange. Further, the benchmarking of parameters, prioritization of alerts and connectivity with various databases is still in the process of implementation. The target date for implementation of phase I of the Stock Watch System had been fixed as 31/3/1998. A representative of SEBI indicated that BSE was able to put a Stock Watch System in place some time in March, 1999. NSE has implemented Stock Watch Phase-I

as per SEBI requirements within the dead line. Next step for the Exchanges was profiling the normal trading pattern of scrips and prioritization of alerts. After completion of these processes, in phase-II all the Stock Watch Systems will be connected with each other so that an overall picture of the market can be taken.

9.39 SEBI started getting formatted reports of the exchanges from October, 1999, regarding market manipulation related matters and on any happening, trends, events, etc. which have a bearing on the risk management and safety and integrity of the market.

9.40 Asked whether none of these reports indicated prevalence of any manipulation prior to 2/3/2001, a representative of SEBI stated :-

“In the formatted reports, we did not get any intimation whatsoever about any trends which were abnormal or where some problem was indicated. However, at the same time, we were getting specific reports related to specific scrips where the Exchanges had made out some case of price manipulation or some irregularity that was followed up subsequently in SEBI.”

9.41 SEBI in its Preliminary Report on investigations in market manipulations in the context of recent market behaviour has observed that though stock exchanges have taken steps to establish surveillance and monitoring systems, it appears that the exchanges have not been able to develop effective level of surveillance and monitoring capabilities yet. It is seen that exchanges have not been able to adequately staff their surveillance departments both in terms of numbers and professional expertise. Preliminary investigations revealed build up of large positions and concentrations by certain entities in specific scrips. However, the exchange reports and responses never indicated these trends. This shows that the surveillance mechanism of the exchanges could not properly capture these concentrations.

9.42 Based on its investigations on market manipulation in the context of market behaviour that prevailed during March, 2001, SEBI in its Preliminary Report made the following suggestions for streamlining and strengthening of the Surveillance system:-

- (a) The Surveillance and monitoring mechanism in the Exchanges needs to be strengthened in terms of infrastructure system and manpower.
- (b) Staff strength and infrastructure of SEBI in the areas of Surveillance, Investigation and Inspection of the stock exchanges and intermediaries need to be urgently strengthened for achieving proactive and improved oversight in the area of monitoring and surveillance done by exchanges and also for expeditious completion of investigations by SEBI.
- (c) Independence of surveillance and monitoring functions in the stock exchanges needs to be secured so that there is no management interference and influence.

9.43 Asked why SEBI having been aware of the weakness in surveillance, monitoring and implementation systems, did not take timely corrective measures, the Chairman, SEBI stated during evidence (14/02/2002) that several steps had been taken and “it is an ongoing process and some more steps have been taken now. They would be taken in future also.” He also added that nobody can say that the system is perfect.

**9.44 In order to improve the surveillance mechanism, the BSE has suggested to the Committee that there should be a centralised surveillance mechanism across all the major Exchanges to oversee the operations of the market participants on a holistic basis. The Committee observe in this connection that although an Inter Exchange Market Surveillance Group set up by SEBI**

already exists for co-ordination on surveillance related issues it is evident to the Committee that the surveillance system in stock exchanges are heterogeneous or in majority of cases do not exist in any modern form. Surveillance mechanisms both in stock exchanges and in SEBI need to be strengthened in order to prevent a crisis. In most capital markets of the world, there are very strong surveillance mechanisms, first at the stock exchange level and then at the Regulators level. SEBI needs to impart a great deal of urgency in this area.

9.45 SEBI has been vested with the power to investigate/inspect suo-motu upon its own knowledge under various regulations. Regulation 5(1)(b) of SEBI (Insider Trading) Regulation, 1992, Regulation 19(1)(d) of SEBI (Stock Brokers and Sub Brokers) Regulation, 1992 and Regulation 7(1) of SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulation, 1995 empower SEBI to initiate suo-motu investigation/inspection upon its own knowledge.

9.46 The Committee desired to know the position about suo-motu investigation taken up by SEBI. The position for the last two years is stated to be as under :—

Year	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01
Total Investigation Cases taken up by SEBI	60	122	53	55	56	68
Cases referred by Exchanges on their own to SEBI	N.A.	N.A.	N.A.	N.A.	12	21
Cases initiated by SEBI	N.A.	N.A.	N.A.	N.A.	22	18
Other <i>suo-motu</i> cases	N.A.	N.A.	N.A.	N.A.	22	29
Cases completed	18	55	46	60	57	46

9.47 During the oral evidence of BSE on 30/10/2001, a representative of BSE informed the Committee that BSE had forwarded nearly 80 reports till date to SEBI requesting them to do further investigation. SEBI stated in a written reply that 77 reports were forwarded by BSE to SEBI during the last two years. 35 reports were received by SEBI in the period October 99 to March 2001 and 42 reports were received by SEBI after April 2001. These are under various stages of investigations/Enforcement Actions after completion of investigations. It was observed from the information furnished by BSE that BSE had forwarded a report on Adani Exports on 12.2.2000 and two reports on Aftek Infosys Ltd.—one on 24.12.1999 and another on 31.10.2000. SEBI's interim report has now found that the prices of scrips of these corporate bodies had been manipulated. According to a representative of BSE, a rise in price coupled with concentrated buying by some financial institutions and others does not alert the exchange. In the context of BSE's investigation of Cyber Space whose share of Rs. 10 went up to around Rs. 2000, the witness said that, "When we looked at its concentration, I could find FII's were buying the shares. Financial Institutions were buying the shares. We never suspected them."

9.48 In respect of early reporting of unusual activity on Stock Exchanges SEBI, in its communication dated 21.6.2000, had drawn the attention of the major Stock Exchanges to the media reports which had indicated heavy concentration in select 6-7 scrips viz DSQ Software, Global Tele, HFCL, Pentamedia, Satyam, Silverline and Zee Tele that accounted for more than 60% of the daily turnover and more than 40% of the total outstanding position at major exchanges. SEBI also pointed out that the daily turnover and outstanding positions in these scrips had substantially increased in the preceding few months and that media reports had indicated sharp fluctuations in trading volumes and prices in these scrips.

9.49 NSE conducted investigation in regard to each of the above scrips and reported to SEBI in 18.8.2000 that institutional interest namely purchase/sale by institutional investors like mutual

funds, FIs, banks, financial institutions, etc., had been observed in these scrips in the normal market; that the clients appear to be widespread and no major concentration was observed; and that from the client profile, no apparent irregularities in the trade could be established. NSE also mentioned in the investigation reports on these scrips furnished to SEBI that each of these scrips, however, were actively traded on other Exchanges as well and given the integrated nature of markets, it would be advisable to consider a wider picture and study the trading pattern in the scrips as witnessed in other Exchanges and the extent of involvement of the group company along with fund flows that supported these volumes.

9.50 During the oral evidence of NSE on 8/10/2001, the Committee enquired whether NSE was certain that there was absolutely no price manipulation even though six or seven scrips accounted for more than 60% of the daily turnover, a representative of NSE said "we could not establish it." NSE has stated in this connection that it does not have any jurisdiction over the clients and does not have jurisdiction to examine the source of funds and securities which supported the trading volumes in the scrip under investigation which is essential for establishing manipulation, especially in a liquid scrip. NSE also pointed out in a post evidence reply that the absence of unique client code and existence of multiple membership on stock exchanges enable manipulation of the price/volume in a security by trading in a circular fashion within or across the stock exchanges and made it extremely difficult for an exchange to detect such activity.

9.51 According to NSE, if any concentration is noticed and the concentration is attributable to buying or selling by institutional investors like mutual funds, banks, financial institutions or foreign institutional investors, then no further enquiry is done. This is due to the fact that institutional clients are regulated under their respective special regulations and are not allowed to speculate. Transactions of FI, IFIs, Mutual Funds and banks are not subject to margin requirements or exposure limits as directed by SEBI. SEBI has clarified in this connection that FIs are required to transact business only on the basis of taking and giving deliveries of securities bought and sold and shall not engage in short selling in securities. Hence FIs are not imposed margin payments.

**9.52 The above instance clearly bring out the apathy of the Stock Exchange and an attitude that since "we could not establish it" no further action is needed. This attitude was visible in stock exchanges as also the regulators.**

9.53 The former Executive Director of CSE (Shri Tapas Dutta) stated in a written reply that SEBI had in the past been informed by the Exchange of the concentrated position of members noticed by the Exchange. However, at that point of time it was perceived as normal phenomenon which was occurring in all the Stock Exchanges concerned.

9.54 To a Committee's query whether any action was taken to find out what was the fund flow during bullish phase of the market, SEBI stated as follows :-

- In regular meetings and interaction with exchanges no feed back was received which warranted initiation of investigation at that time.
- With reference to specific communications from SEBI as regards the behaviour of the ICE sector scrips also, the exchanges never indicated any need for investigation into the behaviour of these select scrips.
- These scrips were very liquid with very large volumes and number of transactions running into thousands of lakhs a day.
- On the basis of their monitoring also, Exchanges never made any reference to SEBI as regards any abnormality in the behaviour of these scrips.

- In response to specific complaints received by SEBI and forwarded to the exchanges, the exchanges did not indicate any abnormality in the behaviour of these scrips.
- Margins imposed on volatile scrips were very high (to the tune of 65%) in exchanges having deferral products like MCFS/ALBM/BLESS.
- Exchanges reported that there was no concentration in trading, circular trading etc.
- Most of the world-renowned securities research organizations gave 'buy' recommendations in their technical research reports even at peak prices for a large number of these scrips. Hardly 10% gave 'sell' recommendations.

9.55 SEBI further stated that there was no information available with SEBI at that time which would have warranted initiation of investigation in such scrips. As the trading in these scrips was not under investigation at that time, there was no occasion for examination of details like funding pattern of brokers etc. Notwithstanding this claim before the JPC, SEBI has also pointed to the numerous circulars it sent out to stock exchanges in 1999-2000 cautioning against unwarranted rises in stock prices, particularly of selected scrips, and asking that exchanges investigate improprieties and illegalities which might account for such unnatural volatility. It is evident that SEBI suspected something might be wrong but, for fear of being held responsible for pricking the balloon, decided to go along with stock exchange reports asserting that all was well instead of fulfilling its regulatory duty of cross-checking complacent stock exchanges replies.

9.56 On 2.3.2001 SEBI decided, "after discussing with major exchanges on 2.3.2001," to conduct a preliminary investigation into what it described as "unusually volatile market behaviour around the end of February and beginning of March 2001." According to SEBI, "there were apprehensions of possible attempts by certain entities to distort the market. This perception got more pronounced in the context of an unusual market behaviour inspite of a well-received Union Budget." The Committee note that the Finance Minister in his reply to the debate on a Calling Attention motion in the Rajya Sabha on 13.3.2001 asked the House to "not link the Budget with the stock market." In his deposition to the JPC, Chairman SEBI has consistently maintained that this was a *suo motu* decision not suggested or influenced by the Ministry of Finance.

9.57 While there was volatility in the market around end-February/early March 2001, market volatility had been more pronounced on several earlier occasions. For example, market volatility in four months of the year 2000 (April, May, August and September) was higher than in either February or March 2001. Also, large falls had occurred at least ten times in the previous year. The single day fall has been more on at least 125 days then in the period which sparked the investigation. While SEBI has undertaken investigations of individual cases, as it is required to do, the investigation launched on 2.3.2001 was the first systemic attempt at unearthing the causes of market volatility.

9.58 The market has fallen the day after the presentation of the Budget on most occasions in the decade of the nineties. The biggest fall—of 520 points—was recorded the day after the Budget was presented in 2000.

9.59 The issue of volatility was raised in the Lok Sabha during Zero Hour on 7 March and debated through a Calling Attention Motion in the Rajya Sabha on 13 March. SEBI's decision of 2.3.2001 thus preceded the expression of Parliamentary concern over volatility in the markets.

9.60 Although the SEBI investigation into the volatility of the market in February and March began on 2 March, the market really collapsed several days later, between 7 and 13 March, by over 150 points compared to the closing index on 2 March, in the wake of the

payments crisis in the Calcutta Stock Exchange. After the payments settlement on CSE, there was a smart rally from 14 March onwards, when the Sensex rose by 350 points in two trading sessions on 14 and 15 March. However, the downward trend became a crash on 29 March once the Ketan Parekh-MMCB-Bank of India imbroglio became public knowledge. In the fortnight that followed, the market lost over 400 points, the closing index on 12 April being nearly 800 points below the close on 2 March. Thus much of the stock market crash of March-April 2001 post-dated the Budget by several days and had, in fact, no relationship to the Budget.

9.61 The Finance Secretary told the Committee that:

“The approach of the Government is really to make SEBI into a very effective and efficient regulator of the capital market which can inspire confidence amongst the various players in the capital market.”

9.62 The Advisor to Finance Minister added:

“it would seem to me that the job of the stock exchange, the job of the regulator, the job of the Ministry of Finance is really to be making sure that there are no irregularities going on..... you need to be constantly on the prowl, be alert that there is no irregularity going on whether it (the market) is going up or going down.”

9.63 The former chairman of SEBI, Shri G.V. Ramakrishna, in his technical briefing to the Committee, held that “weak systems, wrong practices, weak regulation (and) uncoordinated regulation.....led to this scam.” Bearing this in mind, the Finance Secretary was asked about how the Ministry of Finance sought to rectify systemic deficiencies. The Finance Secretary told the Committee that “a lot of interaction was there within the Ministry—interaction with the regulators and reports” and that “a number of discussions were held with the Chairman, SEBI and his team on what are the types of systemic improvements that are needed to make SEBI a better regulator.” His Joint Secretary (Capital Markets) detailed these as including questions of rolling settlements, unique client ID, qualifications of people doing surveillance, “how we do it real time, how do we do it as a systemic or system-based manner so that irregularities are thrown up by a system”.

**9.64 Yet, SEBI appear to have done nothing particularly substantive about several areas of concern, such as:**

- (a) the monitoring and regulation of the Portfolio Investment Scheme and changes therein for OCB and other FII investment in the stock market and not tying up the loose ends in this regard, notwithstanding FIIs having poured in an estimated Rs. 50,000 crore in the stock market since they were permitted to do so in 1994;**
- (b) the mismatch between movement in the primary market and secondary market;**
- (c) the mismatch between the number of listed scrips and the number of actively traded scrips, as also between the number of investors and the disproportionately small number of large brokers capable of moving the market;**
- (d) the rise in private placements to the detriment of the primary market;**
- (e) the absence of any regulator framework for private placements;**
- (f) negligence in checking whether aggressive bull operators during the bull run were overtly or covertly obtaining bank funding to finance stock transactions in the face of regulations designed to moderate volatility.**

9.65 Asked why key issues of regulation were neglected or swept under the carpet notwithstanding the presence on the SEBI Board of representatives of both the Reserve Bank of India and the Ministry of Finance, Governor, RBI explained:

"I would honestly say that maybe, one likes the bull run and one does not like the bear run and, therefore, you always react to adversity and not to good fortune. It could be that issue was not in the mind of anybody at that particular point of time to investigate..... I am saying that with the benefit of hindsight you can take a view today that the bull run was something which was engineered. At that particular point of time, the view which was taken was that this was normal, a natural thing for a highly fast growing economy with IT boom..."

Former SEBI Chairman, Shri G.V. Ramakrishna, testified before the Committee that:

"if these four departments (SEBI, RBI, DCA and CBDT) act in a co-operative manner by sharing information at short and frequent intervals and pulling up people as soon as they are found to have violated some rules, the things will improve."

9.66 It was SEBI's job to ferret out the irregularities and defuse them before they blew up. This was the primary job of SEBI which they failed to do in time.

9.67 Even as SEBI subsequently take up its investigation into "whole gamut of issues", as Finance Minister told in the Rajya Sabha, it did not set any specific criteria for identification of the entities to be investigated. Clear criteria are the essential prerequisite for ensuring transparency in the matter.

9.68 Had SEBI been more active on its own and the Ministry of Finance been more insistent on SEBI measuring up to its "macro-accountability to give comfort to the Government that the regulator is performing his job in a professional manner", as stated by the Finance Secretary, much that went wrong in the period under investigation by this Committee might have been forestalled. The Committee regret that a full decade after the establishment of SEBI, and the many years that have passed since the last JPC Report, SEBI's performance has fallen far short of the expectations reposed in it.

9.69 The reasons for the scam will only be discerned if the Committee are able to analyse why the BSE index reached a phenomenal high in February 2000. Absence of an investigation when the BSE index unusually rose contrary to the fundamentals of the stock markets represents the failure of the regulator. Had steps been taken by the regulator at that relevant time, perhaps the phenomenal rise could have been contained and the defaults avoided. The regulator should have known that regulation of the market could only be provided through constant vigil and in cooperation with various other regulatory authorities. There was sufficient contemporaneous evidence to put the Regulator on vigil.

9.70 To some extent, it is valid to contend, as had been done by the SEBI, that it did not have all the powers necessary to deal with the situation that arose in the unusual and artificial rise of the stock market. But the Committee believe that SEBI had sufficient omnibus powers to take pre-emptive steps had it identified the causes for the artificial rise of the stock market. That SEBI did not even attempt to analyse the problem at the relevant time and sailed along with the so called 'feel good factor', a term used at the relevant time to suggest confidence in the market. SEBI should have acted as an effective regulator.

9.71 The Committee note that the SEBI has not been able to fully investigate the fund flows and the extent of involvement of corporate houses even though NSE had emphasised in its

reports forwarded to SEBI on 18.8.2000 the need to study the extent of involvement of the group companies and fund flows that supported the volumes of certain ICE scrips.

9.72 Though the NSE reported about institutional investors' interests in the ICE scrips in August, 2000, the Committee note that SEBI had not undertaken any investigation to ascertain whether there was any abnormality in the institutional interest. SEBI's investigation taken up after the market crash has, however, revealed that certain OCBs and sub-accounts of FII were misused for parking of shares and creating artificial market.

9.73 The Committee note that BSE had forwarded its investigation report to SEBI on the scrips of two corporate bodies in the month of December, 1999 and February, 2000. SEBI's interim report after the market crash has found that prices of the scrips of those corporate bodies had been manipulated. The price manipulations of these scrips could have been detected and subsequent crisis prevented had SEBI taken timely action.

9.74 SEBI has stated that the primary responsibility of Stock Market surveillance is with the stock exchanges. The Committee note that the stock exchanges are not yet adequately equipped with fully functional stock watch system. The phase-I of stock watch system which was targeted to be implemented by March, 1998 is stated to be still in the process of implementation. According to the preliminary report of SEBI, the exchanges failed to detect excessive concentration in the market due to the deficiencies in the surveillance mechanism. The Committee urge that benchmarking of parameters, prioritization of alerts and connectivity with various data bases of stock exchanges with standard software systems should be fully implemented and made operational in a time bound manner.

9.75 The Committee feel that the Inter Exchange Market Surveillance Group needs to be strengthened and there should be a formal system of exchange of information among exchanges. SEBI should also view independently consolidated information of trades across all exchanges and generate its own alerts.

9.76 The Committee disapprove SEBI's attempt to abdicate its surveillance responsibility and put the entire blame on stock exchanges for failure to detect market manipulations. Ensuring safety and integrity of the market is a pre-requisite for protection of the interests of investors in securities which is the foremost duty of the SEBI. Market surveillance plays a key role in ensuring safety and integrity of the markets and SEBI ought to undertake market surveillance on its own besides overseeing the surveillance activities of the exchanges. This is all the more necessary given the jurisdictional limitations of stock exchanges in their surveillance and investigations. Therefore, the Committee are of the view that there should be a very strong surveillance mechanism, both at the stock exchange level and at the regulator's level. The Committee recommend that surveillance system both in stock exchanges and SEBI should be examined in a holistic manner with a futuristic outlook. To put a system in place that will be effective in early detection of financial misconduct is an inescapable necessity.

9.77 The Committee feel that SEBI needs to be professionalised with adequate in-house manpower having a sense of belonging and commitment to the organization. There should be adequate manpower assessed on scientific basis to man various positions in SEBI.

9.78 As the economy gets more and more liberalised, the Regulatory authorities will have to become more and more efficient and effective. The key to effective regulation is real time surveillance so that in the first instance and as the first signs emerge there is immediate focus on the misconduct or violation in the securities market like price rigging, creation of artificial

market, insider trading and public issue related irregularities. The Committee found total absence of timely alert when the sensex was rising and the volatility in the market had become unusual. Frequently, the Committee got the impression that even when considerable indicators were available the regulators failed to step in firmly.

9.79 Any improvement in arrangement for market surveillance should take into account past failure and learn from it. But at the same time the surveillance set up must be futuristic. Far too often, concerned authorities try to plug the gaps that have surfaced in the past without looking at the possible future dangers and requirements. These are :—

- (a) Large number of stock exchanges make the job of surveillance difficult. With the modern reach of IT, the number of functional stock exchanges are coming down everyday. The rule that a company has to be listed on a regional stock exchange should be done away with.
- (b) All stock exchanges should put a standard stock watch system in place. SEBI should show urgency in this regard. The software should be constantly refined and improved so that the alerts are generated to show abnormal market behaviour and these alerts are available and recorded at the level of stock exchanges and SEBI.
- (c) The regulators—SEBI, RBI, Enforcement Directorate, IT Department, Department of Company Affairs, at present, keep vital information to themselves and shy away from sharing it with each other. Any of these may be privy to a financial misconduct and their input would be valuable to the other agency. Method for sharing information must be formalized.
- (d) Misconduct or violation in the market like price rigging, circular trading, creation of artificial market, insider trading and public issue related misconduct should be clearly defined in detail so that exact indicators are well understood and transparent. And these offences should be listed in SEBI regulations with matching punishment.
- (e) Introduce unique broker and client ID on the lines of PAN in IT Department. Introduce a method of tracking multiple membership across the stock exchanges.
- (f) Introduce uniform byelaws for all exchanges.
- (g) Expedite corporatisation and demutualisation.
- (h) Surveillance must absorb news and views from all quarters, only then will it get early alert. These sources could be press reports, investors complaints, securities industries sources, stock exchanges and banks. Early alerts and quick action, therefore, is not only the function of formal reports and complaints. Therefore, much will depend not only on stock watch system etc. but the persons who are manning these systems, those who are incharge of surveillance wing.

### 3. POWERS OF SEBI

9.80 SEBI has powers under the SEBI Act, Securities Contracts (Regulation) Act, Depositories Act and certain sections of the Companies Act available with it for protecting investors' interests and regulation of the securities market. SEBI has been regulating securities market through the provisions of these statutes.

9.81 During the last four years, action taken by SEBI, after completing investigations, against Stock brokers and Sub-brokers, merchant bankers etc. was as follows :-

Particulars	No. of Cases				
	1997-98	1998-99	1999-2000	2000-01	Total
Refund of issue proceeds	3	2	1	4	10
Impound of auction/close out of proceeds	12	—	—	—	12
Cancellation of registration	2	—	4	1	7
Suspension	39	16	30	4	89
Warning issued	9	17	28	9	63
<b>Total</b>	<b>65</b>	<b>35</b>	<b>63</b>	<b>18</b>	<b>181</b>

9.82 It may be observed from above that out of 181 cases on which action was taken by SEBI, severe action of cancellation of registration was resorted to just in seven cases. The action resorted to by SEBI is mostly in the nature of either "suspension" or issue of warning.

9.83 The total number of prosecution proceedings initiated by SEBI during the last nine years related to 83 cases involving 555 persons. The break up of the prosecution cases initiated by SEBI is as shown below :-

Particulars	1992-93 to 1996-97	1997-98	1998-99	1999-2000	2000-01
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**Under powers delegated under the Companies Act.**

Delay in refund of excess application money, delay transfer of shares and non-payment of dividend.	11	6	4	10	4
Mis-statement in offer document and fraudulent inducement.	5	2	1	3	4

**Under powers given by the SEBI Act.**

Violation of Take-over Regulations	2	1	4	1	—
Fraudulent and Unfair Trade Practices	—	2	4	1	—
Violation of Insider Trading Regulations	—	—	1	—	—
Violation of Portfolio Managers Rules	—	—	—	2	—
Unregistered entities	—	—	—	2	—
Non-cooperation during investigation proceedings	—	—	1	—	12
<b>Total</b>	<b>18</b>	<b>11</b>	<b>15</b>	<b>19</b>	<b>20</b>

9.84 It may be observed from above that in so far as Insider Trading is concerned, SEBI has initiated prosecution proceedings in respect of only one case during the last 9 years and under Fraudulent and Unfair Trade Practices Regulation which was notified on 25.10.1995, SEBI has initiated prosecution proceedings in respect of 7 cases.

9.85 SEBI had mentioned in its 2nd Interim Report submitted to the Committee that if a company/promoters/directors, etc. refused to give information sought from them, SEBI can only file prosecution in criminal court which may take years. SEBI had initiated 12 cases of prosecution proceedings in 2000-01 for non-cooperation during investigation proceedings.

9.86 The Committee observed that Section 15A of SEBI Act empowers SEBI to impose a penalty of Rs. 1.5 lakh for each failure by a person to furnish any document, return or report as per any regulations to the Board. Asked why SEBI had not used the powers to impose penalty of Rs. 1.5 lakhs in cases of non-cooperation, the Chairman, SEBI said during evidence (27.06.2002) that the penalty is not automatic and that for doing that he would have to appoint an adjudicating officer which, according to him, is a fairly long process and takes a minimum of three months. When pointed out that failure to furnish information/document within a reasonable time as might have been fixed by SEBI is something factual and that there could be no point of argument or adjudication on the facts regarding failure to furnish information, the SEBI Chairman, gave an assurance, "Sir, we take your advice seriously. We would like to pursue on that thought." The witness also said that "in one case, it appears that fine has been levied."

9.87 Under Section 24 of SEBI Act, if a person contravenes or abets, the contravention of the SEBI Act or regulations or rules, it is mandatory to punish him with imprisonment or fine or with both, apart from any award of penalty imposed on him under the Act.

9.88 According to SEBI, the SEBI Act does not contain specific provisions for conducting investigations such as:

- Power to search and seize—Vital evidence, which may not be made available during investigations, can only be gathered by searching premises.
- Power to impound documents—Successful prosecution requires production of documents as evidence.
- Power to issue summons to witnesses who are not directly connected with the securities market but have vital evidence e.g. banker or an investor.
- Effective penalty for non-compliance including failure to comply with the summons compelling appearance and attendance etc.

9.89 SEBI has stated that because of its inability to enforce compliance of summons, investigations by SEBI may get substantially delayed. Similarly, lack of other powers such as inability to seize documents or inability to examine persons not directly connected to securities markets may also hamper or contribute to slow progress in investigations.

9.90 It has been further stated that after completion of investigations, though enforcement actions are taken as provided under the various Acts and Regulations, impact of the same many a time is not felt because of inadequacies in enforcement powers. The present legal framework, according to SEBI, does not have provisions for:-

- Power to impound or disgorge ill-gotten gains or profits arising out of market manipulations and insider trading. In some cases, this was done by SEBI under general powers of Section 11 and 11B, but in most cases, these have been challenged in the courts.

- Power to impose monetary penalties. The penalties provided are very meagre and are not commensurate with the gains made or losses avoided.
- Collection of penalty.
- Issuing interlocutory directions pending completion of proceedings.
- Compounding of offences—most of the securities regulators use this power very effectively because this gives immediate impact. Prosecution process takes time and can lessen impact of action taken. So compounding of offences produces greater regulatory impact. In US, majority of cases are decided in this way.
- Power to tender immunity from prosecution.

9.91 SEBI has stated that because of lack of these powers, it has been unable to take adequate action even after an investigation establishes violation of SEBI regulations. Because of lack of these powers, SEBI has been issuing general directions under Section 11B of the SEBI Act, even in cases where specific regulations exist in cases related to market manipulation, insider trading, collective investment schemes, etc. This power is under challenge in large number of courts.

9.92 In order to look into the deficiencies in the Securities laws, SEBI appointed a committee under the Chairmanship of Justice Dhanuka. Justice Dhanuka Committee report submitted in 1998 exhaustively deals with the amendments which are required in securities laws. Subsequently, SEBI has also received recommendations from Prof. N.L. Mitra (Former Director of National Law School, Bangalore). He had also made recommendations for amending the SEBI Act keeping in view the investors protection.

9.93 The recommendations of Justice Dhanuka and Prof. Mitra would by and large cover the amendments that are required for further empowering SEBI and for investors protection. The emergent suggestions which SEBI is presently making can be classified under 4 heads :—

- A. Investors Protection
- B. Investigation
- C. Enforcement
- D. General

#### **A. Investors Protection**

9.94 The objective of SEBI is to protect the interest of investor. Therefore, investors also have to be given further legal rights for seeking protection and redressal. SEBI has already written to the Government requesting the Government to amend the SEBI Act whereby a statutory right is given to an investor to go to a court of law and to seek redressal of their grievances in case these are not resolved through arbitration or other means. SEBI has also written to the Government of India requesting for the amendment of the SEBI Act so that a provision is incorporated whereby the investors are entitled to seek damages, compensation and interest. In other words, if an investor has given money to his broker to buy securities and he has not received the securities, the broker should compensate the investors for the loss of interest and for the damages that he may have suffered.

9.95 SEBI's experience while dealing with the "vanishing companies" and "collective investment schemes" has shown that a Competent Judicial Authority should be empowered to attach the

properties of the promoters/directors. SEBI has, therefore, suggested that Securities Appellate Tribunal (SAT) be specifically empowered to attach the properties of these defaulting promoters/directors and intermediaries. The Committee feel that attaching the properties of defaulting promoter/director and intermediaries by itself cannot provide any comfort to the common investors, though it may be a necessary step in the process of law. What is needed is that the investor must be provided immediate monetary relief. This aspect is dealt in detail in the section on Vanishing Companies in the Chapter "Department of Company Affairs".

9.96 These provisions will ensure that investors have a specific remedy under the Securities Act and they can seek relief against directors/companies/intermediaries, etc.

## **B. Investigation**

9.97 SEBI Act does not contain a specific provision empowering SEBI to conduct investigations. There should be a specific provision in the SEBI Act whereby SEBI is empowered to investigate and retain documents and call for information from the banks, authorities and promoters through the medium of formal written order. In the absence of these specific powers, SEBI's action has been challenged in the courts of law on many occasions. SEBI has already written to the Government requesting the Government to amend the SEBI Act empowering SEBI to call for information from the above entities. SEBI has also suggested that immunity can be given to those people who come forward to give information. This will improve the market intelligence and fact finding ability of SEBI. However this power needs checks and balances to avoid its misuse.

## **C. Enforcement**

9.98 The action taken by SEBI under Section 11B of SEBI Act has been challenged before many Courts. It has been submitted that Sec. 11B is remedial and no preventive or punitive action can be taken under this Section. Many of actions taken by SEBI are, *inter alia*, challenged in the Court on the grounds that the statute does not empower SEBI to take such actions e.g. power to impound monies, power to take temporary measures etc. Therefore, SEBI Act should be amended to explicitly empower SEBI to take temporary/final measures. This will also empower SEBI to take punitive action which are deterrent. In the absence of such powers the penalty imposed by SEBI may not be effective or deterrent. SEBI has cited that the Securities Exchange Commission in USA has the powers to issue cease and desist orders and plea bargaining and pleaded for similar powers.

9.99 The penalty which is provided in the SEBI Act is found to be inadequate. Further, for some offences, such as, for violation of fraudulent and unfair practices, there is no provision for monetary Penalty. SEBI has suggested that the monetary penalty should not be restricted to around Rs. 5 lakh but it should be to the extent of three times the profit made or the losses avoided. In case, the violations involve huge financial implications, the penalty that can be levied should be upto Rs. 25 crore. The Committee are of the view that the penalty imposed should be in proportional to the financial misconduct.

## **D. General**

9.100 Securities Appellate Tribunal (SAT) consists of one member. Enquired about the appropriateness of having a single Member Tribunal, the Chairman, SEBI mentioned (27/06/02) that SEBI had made a recommendation to the Government that SAT should be a multi-member body and added, "We have made out that point very strongly to the Government of India."

9.101 SEBI has recommended to the Government that for expeditious disposal of the cases, a Special Court should be set up for the purpose of dealing with matters relating to the Securities

market. This will ensure that the violators are punished expeditiously. This will also act as a deterrent.

**9.102 The regulatory gaps amongst regulators may work to the advantage of the violators. Therefore, it is very important to have clearly identified regulatory jurisdictions for each regulator. It is important that the jurisdiction of SEBI is specifically earmarked so that there is no confusion in the minds of the investors.**

9.103 For the purpose of restructuring SEBI, it has been suggested to the Government that the SEBI Board be enhanced so that SEBI has the advantage of having more experts on its Board. Under the existing provisions of SEBI Act, the Board consists of six members including the Chairman.

9.104 SEBI has stated in the 2nd Interim Report submitted to the Committee that when the investigations are going on or hearings have started, a campaign is started against SEBI. A similar kind of situation arises when the investigations are completed and final orders are passed against an intermediary/individual and corporate. This is particularly so, as the stakes involved of an intermediary/individual and corporate at the receiving end of these enquiries/orders are quite high. While such individual/intermediary/corporate should have right to appeal and should have freedom to access other legal remedies, this kind of unprofessional behaviour needs to be controlled. For this, it may be necessary that SEBI is given the power of dealing with such situations under the law relating to contempts. In short, SEBI has pleaded that power of Contempt of Court should be extended to SEBI even when it acts as *quasi judicial* body. This would ensure the smooth and dignified conduct of investigations and *quasi judicial* functions of SEBI.

9.105 Asked about the Ministry's view on the question of conferring additional powers to SEBI, the Secretary, Department of Economic Affairs said (10.04.02) :

"We have done a fairly detailed study of the powers of SEBI and the powers which are there with regulators of capital market in other countries, and we have also come to this conclusion that we do need to invest SEBI with certain more powers for doing better investigation "...we have formulated proposals for investing SEBI with more powers, which are currently under consideration in the Government."

**9.106 The track record of SEBI in punishing the wrong doers in stock market has been unsatisfactory. During the last 10 years, SEBI could initiate prosecution proceedings on insider trading in only one case and on fraudulent and unfair trade practices just seven cases. Its record of taking action against violators has also been equally unimpressive. In most of the cases, the offenders were let off after 'Warning' or 'suspension'. Only in seven out of 181 cases, SEBI resorted to cancellation of registration during the last four years. All this is indicative of SEBI's reluctance to take severe action against the offenders of stock market. The Committee are of the firm view that only severe punishment can act as a deterrent to the wrong doers and what market needs is fear of punishment and fear of the regulator. SEBI must keep this in mind while handing out punishment to offenders.**

9.107 Though SEBI's plea for more powers to strengthen its effectiveness cannot be faulted, the Committee got an impression that SEBI was not fully enforcing the powers already vested with it. For instance, though SEBI has the power to impose a penalty of Rs. 1.5 lakh every time a person fails to furnish the requisite information, rarely has this power been exercised by SEBI. Similarly, the provision for mandatory punishment of imprisonment, etc. in addition to award of penalty has scarcely been used. SEBI has been found wanting in exercise of powers already available with them.

9.108 Notwithstanding the record of poor utilisation of powers, the Committee feel that SEBI does experience genuine difficulties in investigation and enforcement due to lack of certain specific powers. These deficiencies had been gone into by Justice Dhanuka Committee. Measures needed for strengthening investors protection have been examined by Dr. N.L. Mitra. SEBI had requested that the following specific provisions might be made in securities laws to enable it to function as an effective market regulator:—

#### Investors Protection

1. Specific right under SEBI Act for investors to approach Courts.
2. Specific right under SEBI Act to investors to claim damages, compensation and interest.
3. Attachment of the properties of defaulting promoters/directors/ companies/entities in a speedy manner.

#### Investigation

SEBI should have

4. Specific power of investigation.
5. Power to impound/retain documents pending investigations.
6. Power to obtain information:—
  - (a) from the banks
  - (b) from authorities such as—MTNL
  - (c) from legal entities like corporates, promoters, who deal in securities market.
7. Power to tender immunity from action for making disclosures of facts relating to contravention of regulation under investigation.
8. Power to obtain information about the source of fund.

#### Enforcement

9. Power to take temporary measures—suspension of an intermediary pending investigation, retain proceeds of securities transaction pending investigation, etc.
10. Power to issue Cease and desist order.
11. Power to disgorge the ill-gotten profits made or losses avoided.
12. Power to Impound ill-gotten money.
13. Power to issue directions debarring persons from dealing and accessing the securities market.
14. Compounding/Plea bargaining.
15. Monetary Penalty:—
  - to be enhanced to Rs. 25 crores or 3 times of ill-gotten profit made or loss avoided.
  - to be provided for violations of provisions of SEBI (Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 1995.
  - where no monetary penalty is provided.
  - Monetary penalty against listed companies.

16. Fine and imprisonment on conviction for violation of SEBI Act, 1992/Regulations through the Criminal Courts:—
  - Fine upto Rs. 25 crores.
  - Imprisonment upto 10 years.

#### General

17. Securities Appellate Tribunal be made a multi-member body.
18. Special Court for Securities market.
19. Number of Board Members in the SEBI be suitably enhanced to include more professional members.

9.109 The Committee are glad to note that the Government have since promulgated an ordinance which, inter-alia, has enhanced SEBI's powers of investigation and enforcement. The ordinance has enhanced the monetary Penalty to a maximum of Rs. 25 crore or three times the amount of profits made. Provisions have also been made to make SEBI a nine member Board and Securities Appellate Tribunal, a three member body. These provisions need to be given effect soon for effective functioning of these bodies. The Committee desire the Government to expeditiously examine the feasibility of implementing the remaining suggestions mentioned in the preceding paragraph. The Committee hope that with the enhanced powers and broad based structure of the Board, SEBI will function as an effective regulator in future.

9.110 Clarity is needed between DCA and SEBI in regulating Capital Market. Full fledged responsibility with authority may be given to SEBI. SEBI should be vested with comprehensive jurisdiction over listed companies and also adequately empowered and made accountable for matters connected with listed companies including jurisdiction over accounting standards, corporate governance, mergers and amalgamations and protection of minority shareholders.

#### 4. DEMUTUALISATION OF STOCK EXCHANGES

9.111 The Committee came across many instances in Stock Exchanges where the brokers who also held positions in the management of the exchanges have acted in their own interests rather than in the interest of the exchange as a business entity. The episode of collection of price sensitive information from the surveillance department by the president of BSE (who was a broker member) and the malpractices by the broker directors in the management of CSE, underlines the urgent need for demutualisation of stock exchanges.

9.112 Stock Exchanges world over are gradually moving to demutualisation with varying approaches such as conversion to from 'non-profit' to 'for profits' operations; commercialization of functions and having them into subsidiaries; listing of shares; and the constitution of demutualised exchanges as companies or corporations etc. In India, of the 23 stock exchanges, only two stock exchanges, *i.e.* OTCEI and NSE, are demutualised. NSE has been from day one the purest form of a demutualised stock exchange as its shares are not owned by the brokers and its management is free from broker control.

9.113 On SEBI's directive of 1993, the governing boards of Stock Exchanges consist of 50% directors drawn from elected Stock Brokers and other 50% comprising nominees of the government or SEBI and Public Representatives. The non-broker members of the governing bodies comprise public representatives who are chosen from members of judiciary, chartered accountants, academicians, experts and nominees of SEBI to include a SEBI official, the regional representative of the DCA and representative of the State Government.

9.114 The Finance Minister announced in the Parliament on 13.3.2001 that the government proposed to corporatise the stock exchanges by which ownership, management, and trading rights would be segregated from each other and legislative changes, if required, would be proposed accordingly to give effect to the corporatisation of stock exchanges.

9.115 The salient points of change which are envisaged to be achieved towards demutualisation mainly consist of following :

#### Change in the structure of the Stock Exchanges

At present, the stock exchanges are either set up as Association of Persons (AOPs), company limited by shares and company limited by guarantee. Three stock exchanges viz. BSE, ASE and MPSE are association of persons, nine stock exchanges are companies limited by shares and twelve are companies limited by guarantee. All the stock exchanges except NSE and OTCEI are non-profit mutual organizations. The exchanges which are AOPs and those which are companies limited by guarantee should be converted to companies limited by shares and all the existing stock exchanges which are presently non-profit entities should become for profit companies. Thereafter, these companies would be liable to pay income tax as any other company.

#### Separation of trading rights and ownership

The trading rights and ownership of the member brokers would be segregated. At present, ownership and trading rights are inextricably linked and except for NSE and OTCEI, to trade on any exchange, a person must become a member of the entity and hold a card or share of the stock exchange. With the proposed segregation, it would not be necessary to own a share in the stock exchange to be able to trade on the exchange.

#### Separation of management from ownership

For demutualisation, separation of management from ownership is required. Basically, the issue involved is composition of board of directors. To achieve this, either the NSE model may be followed or any of the other patterns followed by international stock exchanges which have been corporatised and demutualised could be adopted.

Under the NSE pattern there is no broker representation on the Board of the National Stock Exchange of India Limited. NSE has an Executive Committee which has broker representation.

In the international pattern, different practices have been followed by exchanges regarding the composition and structure of board of directors. In some of the stock exchanges the board of directors are elected by the shareholders and are persons of eminence belonging to the securities industry and listed companies. There did not appear to be any express restriction of the maximum number of directors who could themselves be from the broking firms.

9.116 According to SEBI, corporatisation and demutualisation, as outlined above involve several legal, fiscal and administrative measures. Some of these include, changing the structure of the exchanges as mentioned earlier, valuation of assets, possible grant of fiscal incentives in terms of stamp duty and income tax, financing of share capital, public participation and regulatory issues. Resolution of all these issues would take time and hence, a phased approach for demutualisation may need to be adopted.

9.117 The BSE has proposed a scheme for Demutualisation to incorporate Mumbai Stock Exchange as a public company limited by shares under the Companies Act, 1956 under the name 'BSE Limited'. Under the proposed scheme, the key activities like Clearing and Settlement, Surveillance, Risk Management etc. would be hived off into a separate subsidiary namely, BSE Services Ltd. where there would be professional management and broker members would not have a representative.

9.118 In his budget speech on 28.2.2002, the Finance Minister has stated that the process of demutualisation and corporatisation of stock exchanges is expected to be completed during the current year (2002-03). Asked about the present status in respect of demutualisation in various stock exchanges, SEBI has stated in a written reply dated 3.6.2002 that the first step towards demutualisation has been to ensure that the management and the ownership is as far as possible segregated. It has been made mandatory by SEBI that the Presidents and the Vice-Presidents and the Treasurers of the stock exchanges will not be broker-members and they will be nominated from among the non broker directors. SEBI has issued orders under section 8 of the SC (R) Act for amending the rules and bye-laws of the exchange to give effect to the directive of SEBI.

9.119 The Group set up by SEBI under the Chairmanship of Mr. Justice Kania, the former Chief Justice of India to examine the issues involved in demutualisation of stock exchanges submitted its report on 28.8.2002. The group has, *inter-alia*, recommended the following:-

- a common model for corporatisation and demutualisation be adopted for all the stock exchanges.
- the three shareholders viz. shareholders, brokers and investing public through the regulatory body should be equally represented on the governing board.
- the brokers representatives would be elected by the shareholders.
- the role and hence the posts of Chairman and Chief Executive should be segregated.
- the Chairman of the Board should not be a practicing broker.
- suitable legislative charges should be carried out.

SEBI has also stated that to achieve demutualisation in the way it is envisaged a statutory amendment would be necessary in the SC (R) Act/SEBI Act.

9.120 SEBI had constituted a committee for examining the existing Articles and Memorandum of Association, Rules, Bye-laws and Regulations of Stock Exchanges and framing a uniform set of Rules and Bye-laws to be followed by all the stock exchanges of the country. The committee was constituted on 14.5.1997 and had representation from major stock exchanges of the country and also the Institute of Company Secretaries of India.

9.121 During the oral evidence of SEBI on 15.10.2001, it transpired that SEBI's Committee on Model Rules and Bye-laws had not submitted its report even four years after its constitution. The Committee had only submitted a draft. The JPC expressed their unhappiness over the delay in submitting the final report which had delayed reforms in the functioning of Stock Exchanges. It was only after the JPC's expression of unhappiness, the Committee submitted the report on Model Rules of Stock Exchanges on 21.11.2001. The Sub-Committee of the Committee on Model Rules and Bye-laws submitted its report on Model Bye-laws alongwith draft Model Bye-laws in July, 2002.

9.122 Some of the salient recommendations contained in the report on Model Rules are as under:

- The minimum educational qualification for a member of a stock exchange prescribed as graduate of a recognized university from any discipline. Besides, he should have passed a certificate/diploma course or examination as may be recognised by SEBI from time to time.

- Persons punished for violation of SEBI act, SC(R) Act, or any other rules or Regulations thereunder ineligible to become member for 2 years and persons sentenced to imprisonment by a competent court of law ineligible to become member for 5 years.
- Prior Approval of Stock exchange is made necessary for opening a branch office by a member.
- A comprehensive definition of multiple membership has been evolved.
- In case of multiple membership, a defaulter member of an exchange should also be declared a defaulter *ipso facto* in other exchanges.
- For selection of new members of an exchange, the composition of the selection committee will be in the ratio of 40:60 between members and non-members.
- The power given to the General Body of a stock exchange to amend the Rules and Byelaws of the stock exchange embodied in the Rules of several stock exchanges be modified to retain the power to amend Bye-laws of the stock exchange only.
- In addition to Arbitration, Defaulters' and Disciplinary Action Committee, there should be four other Standing Committee viz., Audit Committee, Membership Selection Committee, Investors' Services Committee and Ethics Committee.
- The composition of all the committees shall be in the ratio of 60 percent non-members and 40 percent members and with the prior approval of SEBI.
- Constitution of committees other than statutory and standing committees, which overlap or conflict, with the functioning of Executive Director should not be made.
- The Committee has renamed the President of the stock exchange as its Chairman who shall be non-executive.
- The Chairman shall deal with any matter relating to the administration, functions working and affairs of the stock exchange only at the meetings of the Governing Board and shall not deal with any of the operational or administrative matters.
- There is no longer any need for continuance of the post of the Vice-President.
- As the functions of the Honorary Treasurer are presently being discharged by the secretariat of stock exchanges, there is no longer any need for continuance of the office of the Honorary Treasurer.
- There is no longer any need to continue the office of the Trustees presently in vogue at some stock exchanges. However, a detailed study of conversion of these stock exchanges into corporate entities from the points of view of tax implications, property rights, payment of stamp duty, etc. be made and that the office of the Trustees at these stock exchanges may continue till conversion of these stock exchanges into corporate entities.
- All powers and functions concerning management, operations and administration of the Exchange to vest in the Executive Director who has been redesignated as 'Managing Director' and who will be the sole deciding authority on matter concerning functioning of the stock exchange.
- The Governing Board of the stock exchange shall authorize the executives of the stock exchange, including the Managing Director, to sign cheques.

- The services of a practicing company secretary be engaged to examine and certify about compliance by stock exchanges of the directives, orders, guidelines, norms and circulars issued by SEBI from time to time and his report to be placed before the Governing Board immediately in the succeeding meeting taking place after submission of such report to the Managing Director.
- A specific provision, prohibiting a member under suspension by the stock exchange or a member whose registration has been suspended by SEBI, from contesting election to the Governing Board for a period of two years from the date of expiry of suspension of trading or suspension of registration by SEBI has been made.
- The Committee has made an enabling provision for *suo motu* appointment of Public Representatives (PR) on Governing Board of the stock exchange by SEBI. A specific provision empowering SEBI to issue to the public representative directions and instructions with regard to affairs of a stock exchange and for the public representative to report to SEBI in that behalf has also been made.
- Selection of the Managing Director shall be made independently by a Selection Committee constituted by the Governing Board with the prior approval of SEBI.
- A detailed procedure pertaining to Appointment, Appraisal, Renewal and Removal of Managing Director (Executive Director) has been prescribed.
- Interested Members not to participate in meetings of the Governing Board.
- The power to expel a member should rest solely with the Governing Board of the stock exchange.
- Power to censure or warn, impose fine, impose sanction or suspend members vested in Disciplinary Action Committee.
- Managing Director (Executive Director) is vested with exclusive disciplinary powers relating to disciplining of members in all aspects of trading and settlement and Market Surveillance. Such Powers would include imposition of fine not exceeding Rs. 1 lakh or such higher amount as fixed by the Governing Board, suspension of a member upto 7 days at a time, suspension of trading in scrip, investigation of members, placing scrips on spot delivery or trade to trade basis etc.
- Elaboration of provisions relating to misconduct, unbusiness like and unprofessional conduct of the members of a stock exchange.
- Budgetary Control to be exercised by Executive Director subject to approval of the Governing Board, however once the budget is approved, Executive Director shall have authority to incur expenditure within the budgetary provisions.
- Publishing of half-yearly accounts by stock exchanges has been made mandatory.

9.123 Some of the Model Rules such as redesignation of President as Chairman and Executive Director as Managing Director, abolition of the post of Vice President, Treasurer and Trustees, role of President etc. are related to demutualisation of Stock Exchanges and can be implemented only after all exchanges are demutualised. In the meanwhile, all stock exchanges have been directed to ensure that no broker member shall be an office bearer of an exchange *i.e.* hold the position of President, Vice-President, Treasurer etc. Order in this regard has already been issued by SEBI for compliance by the stock exchanges and the process of demutualisation of stock exchanges is already on.

9.124 To implement the recommendations of the committee other than the recommendations regarding demutualisation, which are being implemented separately, SEBI advised the Stock Exchanges on 20.12.2001, to incorporate these Model Rules in their Articles/rules within a period of two months. The model rules can be implemented after the approval of members of the exchange in a general meeting and published in the Gazette. As on 31.7.2002, 7 exchanges have obtained the approval of its members in the AGM/EGM. In 4 exchanges, model rules have been approved by Governing Boards and are yet to be approved by its members in AGM/EGM. In remaining 12 exchanges, the model rules are yet to be approved by Governing Board/AGM/EGM.

9.125 The events that led to the payment crisis in CSE and the episode of Anand Rathi in BSE underline the urgent need for demutualisation of Stock Exchanges. The Committee note that SEBI's Model Rules are in the process of implementation by Stock Exchanges. SEBI has also recently prohibited broker-members from holding any position of office bearer in Stock Exchanges. A group set up by SEBI under the Chairmanship of Justice (Retd.) Shri Kania to examine demutualisation issue has given its report recently. Though the process has started, the Committee hope that SEBI will implement the recommendations of Kania Group expeditiously and as announced by the Finance Minister in his budget speech on 28.2.2002, the process of demutualisation and corporatisation of Stock Exchanges will be completed as soon as possible.

9.126 The Committee are of the opinion that the proposed form of demutualisation should contain a judicious blend of the best elements of NSE pattern and those of other models of demutualisation obtaining in foreign countries so as to safeguard the interests of investors and bring in greater transparency and efficiency of the exchanges.

9.127 The Committee are also of the view that corporatisation of an exchange leading to unbundling of various functions such as surveillance, risk management, clearing and settlement, etc., into a separate subsidiary as proposed by the BSE should not in any way dilute the regulatory functions of SEBI *vis-a-vis* the subsidiaries. The Committee emphasise that the SEBI should extend its proactive supervision on the functioning of these subsidiaries and keep constant vigil in the form of periodic inspections of the activities of subsidiaries.

## 5. SYSTEMIC REFORMS IN THE WORKING OF STOCK MARKET

### A. Rolling Settlement

9.128 According to BSE, one of the recommendations made by the Committee constituted by 'The Group of 30 countries' in March 1989 for shortening the time between the trade date and settlement was adoption of a rolling settlement system in which final settlement for all trades should occur no later than T+3 *i.e.* Trade day + 3 days.

9.129 In the traditional Account Period Settlement system the trades done over five trading days (in a week) are accumulated and net obligation is settled within seven days of the last trading day, so in effect it takes about fourteen days for the settlement of the transaction to take place.

9.130 The rolling settlement entails the settlement of a transaction after specific days. In such a system, the trades done on a day would be settled after specific days, *e.g.* if the settlement is on a T+5 basis, then a trade done on a day, 'T' would be due for settlement on the fifth day after 'T' day. In a rolling settlement, trades are settled on all business days of the week. This reduces the settlement risk. Besides, investors get their money and securities for their sale and purchase transactions respectively earlier than in the Account Period Settlement. The rolling settlement reduces the cost of the transaction as the settlement period is reduced and also

ensures faster and efficient settlement of transactions. This system is in tune with the international best settlement practices.

9.131 The Government in May 1997 had written to SEBI among other things “desirability of implementing a uniform settlement on T+5 on a rolling basis for our Exchanges. According to SEBI, the successful introduction of rolling settlement is predicated on the availability of certain infrastructure with the stock exchanges which *inter-alia* include (i) dematerialisation of securities, (ii) effective and efficient fund transfer mechanism including electronic fund transfer (EFT), (iii) effective securities lending and borrowing mechanism (iv) risk hedging mechanism such as futures and derivatives market to maintain volume and liquidity in the capital market. These facilities were not available at that time. Derivative was incorporated as security in Securities Contracts (Regulation) Act, only in 1999 and derivative trading began in June 2000. Without Electronic Fund Transfer and substantial dematerialisation of securities, it was difficult to have daily physical settlement in a country like India with vast and wide spread investor population. Dematerialisation at that time *i.e.* in 1997 had just started and was in its nascent stage.

9.132 SEBI Board in its meeting held on 5.1.1998 decided to introduce the rolling settlement on T+5 basis in the demat segment with effect from 15.1.1998 on voluntary basis. The number of such scrips was limited then. However, the trading in the rolling settlement segment did not pick up for a considerable period of time.

9.133 When the voluntary facility failed to attract investors, SEBI constituted a Committee in August, 1999 for working out the modalities for the smooth transition to the rolling settlement. By that time, wide scale dematerialisation had already taken place and more than 90% of trading was in demat form. The Committee recommended introduction of compulsory rolling settlement (CRS) on T+5 basis in phased manner. CRS was introduced on experimental basis *w.e.f.* 10.1.2000 for 10 scrips and was extended to 163 scrips *w.e.f.* 8.5.2000. Since 2.7.2001, it is available in 414 scrips consisting of all ‘A’ Group shares.

9.134 SEBI had constituted a Committee on Uniform Settlement for all the stock exchanges in August, 1997. Asked about the action taken in this regard, SEBI Chairman stated during evidence as follows :

“The Committee met several times but it could not give its final report. The matter was discussed repeatedly and there were very heated exchanges as well. The point was that in case of uniform settlement, the date of settlement would be affected—let me be very honest with you—and some of the smaller exchanges would have closed down that very day. We were already facing this problem and some of the exchanges had closed down”.

The witness added,

“One of the points that emerged was that if we have to introduce it (Uniform Settlement), then let there be rolling settlement. If you have rolling settlement then automatically there would be uniform settlement”.

9.135 Rolling settlement will be facilitated if both funds and securities can move instantaneously. Transfer of funds has become quicker with facility of electronic fund transfer (EFT) provided by private sector banks. Many nationalized banks also provide EFT in major towns where maximum trade is generated. RBI has electronic funds transfer facility in 15 centres where it has got its offices. RBI is trying to integrate with other commercial banks who are having EFT facilities. RBI is also in the process of implementing Real Time Gross Settlement System (RTGSS) which is expected to be ready by March 2003. RTGSS is normally used all over the world for high value funds transfer, either by banks own account or on behalf of their customers.

9.136 Rolling settlement on T+5 basis has since been introduced in all scrips and has now moved to T+3 system.

9.137 To a question whether the current scam could have been averted had rolling settlement been introduced earlier, SEBI has stated that there is at present no empirical evidence or study with SEBI to conclusively prove that the introduction of rolling settlement on a wider scale could have minimized the impact of the events of March 2001. While it is true that most markets around the world have adopted rolling settlement, events in the last few years have shown that the markets are not immune to extreme volatility in stock prices and occurrence of financial crisis. Indeed there are examples of large broker failures as a result of concentrated positions compounded with extreme market volatility in several developed markets. In fact, in India also there are several cases of companies in the category of compulsory rolling settlement wherein there has been price manipulation.

**9.138 Despite the fact that rolling settlement is beneficial to investors in terms of reduction in risk, cost and settlement time and that its adoption was recommended by 'The Group of 30 countries' as early as in March 1989, the Committee regret to note that SEBI has taken over a decade to develop the infrastructures required for introduction of rolling settlement and for its actual commencement. The Committee note that the settlement cycle has now moved to T+3 system. The Committee feel that with electronic fund transfer facility available in most of the commercial banks the implementation of the Real Time Gross Settlement System (RTGSS) is expected to be completed by March 2003. It should be possible to further reduce the settlement cycle to T+1 system to all scrips. However, this step should only be taken very carefully after RTGSS becomes fully functional even in remote corners of the country and payments timing can match the settlement cycle.**

#### **B. Carry forward System and derivatives**

9.139 SEBI had expressed the view before the Joint Committee which enquired into irregularities in Securities and Banking Transactions (1993) that the carry forward (badla) transactions should be disallowed and transactions conducted strictly on a delivery basis and trading in futures and options be permitted in a separate market. In December, 1993, SEBI ordered discontinuance of carry forward transactions. The chronological developments in this regard are as follows:—

- In the ATR of July 1994, the Government stated that introduction of options in securities would require an amendment to SCR Act as there is a prohibition of options under Section 20 of the Act. Further, Government stated that SEBI banned badla but subsequently decided in March 1994 to allow carry forward facility under a framework of transparency and effective regulation.
- Based on recommendation of a Committee set up by SEBI in 1995, the Revised Carry Forward System was introduced with several safeguards and transparency.
- The revised carry forward system was further modified in 1997, on the recommendations of another Committee set up by SEBI, to further strengthen the system and make it more effective.
- With the introduction of rolling settlement, a new mechanism of carry forward and other deferral products were permitted in 2000.
- Subsequently all carry forward products namely ALBM/BLESS/MCFS were discontinued w.e.f. 2.7.2001, with introduction of rolling settlement to cover larger number of scrips.

9.140 Concerns were expressed by certain quarters that there is no liquidity in the market due to abolition of badla. Depositing before the Committee in this regard a former broker director of BSE (Smt. Deena Mehta) stated as follows:

"Sir, badla system, as we say, was a financing system available in the market. Everywhere financing is something that is an absolute structural necessity for any market. If some deficiencies are there in any system, they need to be corrected. But doing away with the badla system or I would call it a financing system totally, people will resort to unorganised market. The liquidity has totally gone away from the market. There has been as high as 80 per cent fall. In certain active scrips, 99 per cent fall is in a number of shares that are traded".

However perception on this subject varied considerably.

9.141 Shri R.H. Patil, Former Managing Director, NSE who appeared before the Committee as an expert, however, opined as follows:

"I do not think that abolition of badla would lead to lack of liquidity.... Liquidity is a function of the market safety. Safer the market, shorter the settlement cycles, the liquidity automatically comes..... In 1994, when badla was banned, we found a very interesting thing happening. When badla was operating, the liquidity was concentrated in 'A' Group stock, but the moment badla was abolished in 1994, the number of stocks traded per day increased. I remember a figure that on some days 4,500 stocks were traded in BSE. But after badla was re-introduced, the number came down to less than 2,000. What happens is, once you introduce badla everybody's attention is diverted to badla and people start trading in other stocks. I think one of the biggest losses as a result of this is, what is called, value investing. This means, people do not invest based on the fundamentals of the company, that is, the current profitability, but more by the badla possessions, whether you have excess possession and they just start making money....

I do not deny that if badla is operated absolutely by the right principles, then it is not an unsafe product. But the point is that the way the badla market has evolved a tradition of by-passing the rules has got established. I think, it has created crisis all along. If we introduce the new product like future and options, then being a totally new product, the market always accepts discipline. We can introduce the harshest discipline".

9.142 The then Chairman of SEBI (Shri G.V. Ramakrishna) during his briefing of the Committee said that he imposed the ban on badla in December, 93 because of the refusal of brokers to segregate the trades into Badla trading and spot trading.

9.143 During evidence of SEBI held on 15/10/2001, the Committee desired to know the reasons for introduction of revised carry forward system in March, 1995. In response, the Chairman, SEBI stated as follows :

"Till we introduced the derivatives and till the ground was ready for the introduction of derivatives, we needed some kind of deferral products. In between there was some problem. This was the reason why these products were allowed".

9.144 In December, 1993, SEBI directed the stock exchanges to discontinue carry forward transactions. Following this, Members of the stock exchanges having carry forward facility stopped the trading and went on strike. After several days of stoppage of trading, and following discussion with SEBI by a delegation of BSE, trading was resumed in all the exchanges.

9.145 After wide ranging discussions with all the players involved, SEBI decided in March 1994 to allow the carry forward facility in the stock exchanges under a frame work of transparency and effective regulation. The stock exchanges, however, did not adopt the revised carry forward system. Subsequently, in May 1994, BSE submitted a fresh proposal which did not go far enough in adhering to the principles laid down by SEBI.

9.146 SEBI set up the G.S. Patel Committee to review the system of carry forward transactions and adopted the system recommended by the committee in March 1995. The System was further revised on the recommendations of Prof. J.R. Varma Committee in Oct. 1997. The new system was called Modified Carry Forward System (MCFS).

9.147 Subsequently, Prof. J.R. Varma Group recommended that deferral products should cease to be available from 02.07.2001 and that SEBI and the exchanges should work towards introduction of individual stock derivatives viz., option/futures in selected stocks by that date. These derivative products would perform the hedging functions currently being performed by deferral products. The SEBI accordingly discontinued the deferral products.

9.148 All the developed markets have derivatives trading that provides a risk management tool to hedge the risk in the underlying market. Derivatives, however, could not be introduced in India in view of prohibition of all options in securities with Securities and Contracts (Regulation) Act. Since introduction of trading in derivatives required withdrawal of these prohibitions, the Government on 25.1.1995 promulgated an ordinance namely the Securities Laws (Amendment) Ordinance, 1995 withdrawing the prohibition by repealing section 20 of the SC(R) Act. The market for derivatives however, did not take off, as there was no regulatory framework to govern trading of derivatives.

9.149 L.C. Gupta Committee appointed by SEBI in November 1996 recommended in its report of March 1998, the introduction of financial derivatives in India in a phased manner starting with the index futures and followed by options on index and options on securities.

9.150 The introduction of financial derivatives remained pending for want of approval of amendment in definition of "Securities" to include derivatives under Securities Contracts (Regulation) Act, 1956. Pursuant to the amendment in the definition of securities under SC (R) A in December 1999, NSE and BSE started trading in index futures contract in June 2000. Later, SEBI also approved the proposal of BSE and NSE to start trading in index options contracts in June 2001 and also the option contract on individual stocks in July 2001.

9.151 The Committee are not happy with the way the matters concerning carry forward system were handled. SEBI's stand before the previous JPC was for disallowing carry forward transactions and permitting futures and options. SEBI, however, went about imposing a ban on carry forward transactions in December 1993 without having derivatives viz. futures and options in place. As a result, SEBI had to lift the ban shortly afterwards in March 1994. Derivatives could be introduced on regular footing only in 2000-2001 after removal of legal impediments. In the meantime, the carry forward system underwent a revision in March 1995, underwent further revision in Oct. 1997 before being banned again in July 2001. The Committee emphasise that *ad-hocism* should not be allowed to rule in SEBI at least in future.

9.152 The Committee suggest that there should be proper risk management measures to regulate derivative trading. SEBI should also explore the desirability of introducing a formal system of exchange-operated margin trading system to bring liquidity in the stockmarket.

### C. Short Selling

9.153 SEBI had constituted B.D. Shah Committee on 22.11.1996 to recommend among other things, suitable modalities for regulating the short selling. The Committee submitted its report in December 1996 and recommended for disclosure of scrip-wise net 'short sales position' and differential margins to restrict short sales. While SEBI mandated disclosure of scrip-wise net short sale position, it did not agree to the margin mechanism to deal with short sale on the ground that the purpose of margin was to ensure solvency and not regulation of market.

9.154 Contrary to its own above stand, SEBI on 16.6.1998 prescribed additional margin of 10% on total net outstanding sale position scrip-wise at the end of each day in view of the prevailing market turmoil. The B.D. Shah Committee on Short Sales was also reconvened in June, 1998 to review the regulation of short sales. The Committee discussed the question of introducing the rule of prohibition of short sales on down-tick at its meeting held on 22.6.1998. The participants especially, the exchanges indicated strong reservations about the down-tick rule as according to them it would need a software change which would take sometime. The issue of down-tick rule was again discussed at the meeting of the Committee held on 22.4.1999 and was agreed to in principle. However, the representatives of exchanges again expressed the view that to introduce down-tick rule, wide ranging changes in the software would be necessary and they would be getting back to the Committee about software changes and time needed to implement the same. In September 2000, Shri B.D. Shah tendered his resignation on health grounds and Dr. D.C. Anjaria was appointed as Chairman of the Committee.

9.155 Expressing concern over high degree of volatility in capital market and apprehending market manipulation by unscrupulous players in the market, the Ministry of Finance on 26/4/2000 forwarded certain suggestions to SEBI which included short selling. The Ministry pointed out that in equity markets of some developed countries short selling is not permitted when there is excessive volatility on the 'downtick' and asked SEBI to look into the possibility of introducing a similar restriction in our markets as it would reduce possibility of panic selling. Further, on 15.5.2000 the Ministry suggested some more measures which included a suggestion regarding ban on short selling on downtick.

9.156 SEBI's Committee on Short Sales under the Chairmanship of Dr. Anjaria met on 2.1.2001 and discussed the downtick rule as prevalent in the New York Stock Exchange and Nasdaq market, where generally securities could not be short sold on downtick and proposed that a similar kind of restriction could be considered for the Indian market. There were fundamental structural differences with respect to the experience of international market and the Indian Market regarding short sales. The main differences identified were that the international markets are on rolling settlement basis and most of them operate on quote driven system of execution of transactions, besides in these markets securities lending facilities were widely available. In Indian markets, the rolling settlements was then in its nascent stage, market are order driven and the securities lending facilities had not yet picked up. In view of these differences, it was felt that it would not be possible to implement the same type of regulations on short sales as is prevalent in international markets. SEBI has stated that following the events in the stock markets since March, 2001, no further meeting of the Committee on short sales could be held.

9.157 During evidence of SEBI (16.10.2001), the Committee asked why SEBI allowed short selling on downtick, when it was not allowed anywhere including US, the Chairman, SEBI stated as follows :—

“We discussed this. There was a serious difference of opinion in the risk management group. Only in US downtick is banned. This has been going on since the great depression of 1933. They are also thinking of removing this. In the order-driven system, which we have, downtick is a very difficult proposition. In fact, once or twice we did it. We were warned by the financial experts and by the Government, by the Members that SEBI is meddling with the market. When the prices go up, they did not fix the prices”.

9.158 The Committee regret to find that SEBI has not been able to arrive at any definite policy on measures concerning short sales. It had rejected initially the recommendation of its Committee on short sales in December 1996 for imposition of margins to restrict short sales. Later, reversing its own stand SEBI started prescribing margins on net outstanding sale positions from June 1998. The question of introduction of the rule of prohibition of short sales on downtick has been under the consideration of SEBI's Committee on Short Sales since June 1998 without any final recommendation in sight even after four years. The Committee urge that SEBI must look into these issues seriously and expeditiously formulate a clear policy taking all aspects into account.

9.159 There is RBI restriction on bank loans against the security of shares to Rs.20 lakh per borrower. However, it appears that no such restriction has been imposed by SEBI on stock lending by approved institutions (such as SHCIL) against the security of money deposited with them. Such anomalies seem to favour one section of brokers (Short Seller) and create asymmetry in the financial system. The Committee suggest SEBI to look into this issue and take appropriate corrective steps urgently.

9.160 The Committee feel that in future in relation to Stock Lending Schemes, SEBI must ensure that there is proper segregation of cash and derivatives sectors.

## CHAPTER-X

### RESERVE BANK OF INDIA

10.1 The Reserve Bank of India was established on 1.4.1935, in accordance with the provisions of the RBI Act, 1934. The Bank's main functions are:—

- (i) operating monetary policy with the aim of maintaining economic and financial stability and ensuring adequate financial resources for development purposes;
- (ii) meeting the currency requirement of the public;
- (iii) promotion of an efficient financial system;
- (iv) foreign exchange reserve management;
- (v) the conduct of banking and financial operations of the government.

Since the onset of the process economic reforms, including the on-going liberalization and globalization of the economy, the role of the RBI as the Regulator of the financial sector has grown and diversified. What control is to the command economy, regulation is to the market economy. Therefore, an important dimension of this Committee's enquiry relates to the regulatory role of the RBI in the context of the Stock market Scam and Matters Relating thereto.

10.2 Reserve Bank of India is regulator for all the banks in the country and as a regulator, apart from commercial banks, also supervises Co-operative banks, Non Banking Finance Companies, Financial Institutions etc. Thus the entire institutional function of providing finance comes under the regulatory oversight of the RBI.

10.3 The overall objective of central banks and bank supervisory agencies has over time, moved from narrow depositor protection objectives to broader financial stability objectives. This brings greater responsibility on central banks for ensuring that financial markets are not disrupted or individual failures, if any, do not mar the financial system or lead to financial instability. This mandate to the central banks does not imply that central banks are no longer concerned with depositor protection. As a matter of fact, financial stability is superset with larger objectives which, amongst others, also covers the area of depositor protection. The fine distinction sought to be made is that while a regulator cannot forestall mischief or fraud in an individual bank, the larger role of the regulator is to ensure that this does not spill over to other institutions and cause a contagious collapse. This important movement of mandate to central banks internationally would be necessary to appreciate and evaluate the working of the Reserve Bank of India in the context of the stock market scam.

10.4 During the course of the examination of the present scam, the irregularities perpetrated by some of the private banks and co-operative banks have once again been exposed, making the Committee deliberate on the regulatory and supervisory role of the Reserve Bank of India in respect of the functioning of these banks. Their observations/suggestions in this respect are delineated in the succeeding paragraphs.

## **A. COMMERCIAL BANKS**

10.5 The Banking Regulation Act 1949 vests requisite powers with the RBI for supervising the working of the commercial banks. Till 1993, regulatory as well as supervisory functions over commercial banks were performed by the Department of Banking Operations and Development (DBOD). Subsequently, a new Department of Banking Supervision (DBS) was set up to take over from DBOD supervisory functions relating to the commercial banks. In order to have integrated supervision over all credit institutions i.e. banks, development financial institutions and non-banking finance companies, a high powered Board of Financial Supervision (BFS), comprising the Governor of RBI as Chairman, one of the Deputy Governors as Vice-Chairman and four Directors of the Central Board of RBI as members, was set up in November 1994 under the aegis of the RBI. For focussed attention in the area of supervision over non-banking finance companies, the Department of Supervision was further sub-divided in August 1997 into the Department of Non-Banking Supervision (DNBS).

10.6 The main instrument of supervision has traditionally been the periodical on-site inspections of the affairs and books of accounts of the banks. The inspection is system-based and not transaction-based in keeping with international practice. It covers the Head Office and a few selected controlling offices and branches in such a way that the coverage of advances is about 40% to 50% of total advances of the bank. An evaluation of the financial condition, quality of management, and compliance with regulatory guidelines by the bank is carried out during the inspection. The system of on-site inspection has been reviewed from time to time by RBI for improving its scope and effectiveness. Following the recommendations of the Narsimham Committee (1991), banks have been advised to implement prudential regulations relating to income recognition, asset classification, provisioning and capital adequacy standards.

### **NEW SUPERVISORY STRATEGY:**

10.7 The Department of Banking Supervision, with the approval of the BFS, has formulated and put in place a new supervisory strategy. Besides retaining the importance of the on-site inspections, the new strategy focuses on three other areas, viz. off-site monitoring through the introduction of a set of returns; strengthening the internal control system in banks; and increased use of external auditors in banking supervision. The periodicity of inspections of banks has also been changed to an annual cycle for all banks.

10.8 In pursuance of the above strategy, the following measures have been taken:—

(i) Restructuring of the Annual Financial Inspection: The Annual Financial Inspection (AFI) system has been recast on the lines recommended by the Padmanabhan Working Group (1995) and the new AFI is more focused on statutorily mandated areas of solvency, liquidity and operational health of the banks. It is now based on the internationally adopted CAMEL (Capital adequacy, Asset quality, Management, Earnings, Liquidity) model, modified as CAMELS (S for Systems & Control) to suit the needs of the Indian banking system. This system has been introduced from July 1997. At present all banks are inspected at an interval of one year. Public sector banks (other than SBI) and large private/foreign banks are inspected with reference to their position as on March 31 every year. SBI is inspected once in two years though the Local Head Offices of SBI are inspected annually. Other private sector banks are inspected with reference to their position as at the end of the last quarter/date closer to the commencement of inspection. The completed inspection reports are issued to banks within three months from the date of commencement of inspection. After the issue of the inspection report to the bank, the findings of the inspection are discussed with the Chairman/Chief Executive Officer of the concerned bank by Deputy Governor/Executive Director/Chief General Manager and a definitive, agreed

and time-bound monitorable action plan is worked out for implementation by the bank concerned. A memorandum containing the summary of findings, along with the comments of the Chairman/Chief Executive Officer of the bank, is placed before the Board for Financial Supervision. The directions of BFS, if any, on the findings of the inspection are also taken up with the bank concerned. The position of rectification of deficiencies is closely monitored. Besides the discussions with the Chief Executive Officers of banks on the findings of Annual Financial Inspections. With effect from January 2000, a system of quarterly monitoring through discussions with the bank's senior executives on the planned strategies for growth and improvement in operational efficiency has also been introduced.

The Committee queried why the annual inspections carried out by the RBI are becoming a mere formality as the wrong doings pointed out in the earlier inspection reports are repeated by the banks again and again. The Governor, RBI in his deposition before the Committee submitted:

"...whether the RBI's inspection system is effective enough to prevent misuse, diversion and so on and so forth and whether they are taken seriously or not, my impression is that the RBI's inspection reports are taken seriously. The problem may be in analyzing by the RBI whether the problem is serious enough to warrant a penalty. If a penalty has to be levied, a penalty is also levied in a number of cases for dereliction and so on. Our inspection systems are essentially two fold. One is that there is a delay. Report of 2001 says that the whole process would be completed by 12 months later. There is an inspection because this inspection has to be based on account. By June or July you would be having the account. Then the inspection team would go there. It takes two to three months time to inspect. Then they have the report. Then that report is discussed with the Managing Director or the CEO. Then that report is put up before the Board for Financial Supervision. So there is a lapse of time. This is one thing. Second is that in large number of these areas, the problem may not be serious enough. Any inspection team which goes would find even with the best of banks some problems, issues and differences of views, which are all analyzed."

On being asked as to what penal action is taken by RBI in the case of non-compliance by the banks, it was stated that the maximum penalty imposed in such cases as provided under the law is Rs.5 lakh. RBI also furnished a list of 44 banks which had violated the guidelines and on which a monetary penalty of Rs.5 lakh was imposed by them. RBI has further informed the Committee that during the period 1995-2001, penalties have been imposed on some banks on more than one occasion for violations of RBI guidelines relating to different aspects at various points of time. Action against officials for not adhering to RBI guidelines/bank's own internal guidelines is initiated by the banks, taking into account their culpability.

The JPC, 1992 had pointed out grave shortcomings in the audit of banks by the statutory auditors and recommended that the Government should subsequently consider setting up of an independent central audit authority to replace the fragmented system of audit presently adopted by individual banks. The banking industry is subject to external commercial audit and also external supervisory control of the RBI. The supervisory system comprises on site inspection as well as off-site surveillance. In addition to creating in 1994 a high powered Board for Financial Supervision (BFS) in RBI comprising of Governor as its Chairman along with one of the Deputy Governors as Vice Chairman and four directors of the Central Board of RBI as Members with the mandate to exercise the powers of supervision and inspection in relation to the banking companies, financial institutions and NBFCs, the system of inspection is elaborate and in several ways goes deeper than the audit undertaken by the external auditors. Thus, in the case of banks, audit by external auditors is supplemented by intensive supervision by the RBI. Inspite of

these measures, owing to the low frequency of on-site inspections by RBI and the long time gap between the scrutiny of the findings of such inspections and the rectification of these irregularities by the management of the banks concerned, weaknesses in RBI supervision have persisted belying the fruits of the augmented supervisory efforts of RBI. **The Committee have found both external audit and RBI supervision to have been weak and ineffective. The problems which surfaced in private sector banks like Centurion Bank, City Cooperative Bank, MNCB etc. seem to be primarily attributable to prolonged post-inspections proceedings. These problems of individual banks could have been avoided by strict insistence on the part of RBI on the management of the banks concerned for immediate rectification of the irregularities and adherence to prudent norms**

(ii) Off-Site Monitoring System: As part of the new supervisory strategy, an Off-site Monitoring and Surveillance System (OSMOS) was introduced in 1995, where banks were required to submit DSB Returns from the quarter ended March 1996. Systemic Reports/Reviews on important banking operations are also generated to facilitate policy formulation or to assess the impact of monetary and credit policy changes.

(iii) Internal control in banks: With the objective of strengthening the internal control systems in banks, instructions based on the Jilani Group's recommendations were issued to the banks for implementation. The Committee were informed by the RBI that out of 79 recommendations made by the Committee, the 25 recommendations which were made mandatory have already been implemented by each of the scheduled commercial banks and compliance reports in this regard have also been furnished.

(iv) Strengthening of the Audit system in banks:

(a) External Audit function: The external auditors who are entrusted with the responsibility for statutory audit of annual accounts of banks have been increasingly used as extended arms of the supervisory system. They are now required to verify and certify certain other aspects like adherence to SLR, prudential norms relating to income recognition, classification of assets and provisioning, capital adequacy and financial parameters being disclosed in the balance sheet of banks. To bring in further transparency a system of half yearly limited review of accounts by statutory auditors is being introduced in public sector banks from 30.9.2001.

(b) Additional responsibilities given to auditors after 1992: The external auditors have been assigned additional responsibilities after 1992 and they are now required to furnish certain certificates/validations, in terms of various circulars/guidelines issued by RBI, in respect of (i) Verification of SLR requirements under section 24 of BR Act, 1949; (ii) A certificate to the effect that the bank has been following RBI guidelines regarding (a) asset classification, (b) income recognition (c) provisioning, and investment transactions/treasury operations; (iii) A certificate in respect of custody of unused BR forms. (iv) Authentication of bank's assessment of Capital Adequacy Ratio; and (iv) Certification regarding DICGC items.

(c) Additional disclosures in the balance sheet of banks: To bring about more transparency in the accounts of banks, they are required to make additional disclosures in their balance sheets in respect of (a) Percentage of shareholding of the Govt. of India (b) Percentage of net NPAs to net advances (c) Details of "Provisions and contingencies" debited to the P&L Account during the year (d) Maturity pattern of foreign currency assets and liabilities and (e) Movement of NPAs.

(d) Audit Committee of the Board (ACB) : Indian banks have been advised in April 1994 to constitute an Audit Committee of the Board (ACB), headed by a Non-official Director, to oversee the operation of the total internal control functions in the banks. ACB is required to have focused attention on compliance with RBI and Government of India instructions, findings of on-site Inspection of RBI and Internal Inspection.

(e) Concurrent Audit system: In pursuance of the recommendations of the Ghosh Committee, a system of concurrent audit was introduced in banks. The system was introduced initially at large and exceptionally large branches to serve as administrative support to branches, help in adherence to prescribed systems and procedures and for timely detection of lapses/irregularities. Detailed guidelines were given to banks on 11.10.1993. Subsequently, the Jilani Working Group which reviewed the Internal Control and Inspection/Audit System in banks, reviewed among other things, the working of the concurrent audit system and gave its recommendations for improvements. Accordingly, fresh guidelines were issued on 14.8.1996, according to which the coverage of business/branches was broadened. As per the revised instructions, all the branches undertaking Treasury functions and all Dealing Rooms are to be subjected to continuous audit. The coverage of the business should ensure that not less than 50% of the total credit and other risk exposures of the bank and not less than 50% of the aggregate deposits of the branches are covered by concurrent audit. At the same time, concurrent audit should cover all large and exceptionally large branches; special branches handling forex business; branches having dealing rooms and problem branches rated as poor/very poor.

**10.9 The Committee regret that they have found during the course of their examination that although the system of concurrent audit was introduced, in some banks the auditors had not been appointed for months together. The Committee stress the crucial role of ensuring concurrent audit in the regulatory functions of RBI and, therefore, recommend that this must not be relegated during the restructuring of banks. RBI must ensure adherence to its guidelines on concurrent audit.**

**10.10 The Committee also regret that although the last JPC had recommended action against 17 auditors, little was done in this regard.** 5 cases were reported to have been closed at the *prima facie* stage and 3 on consideration of the Reports of the Disciplinary Committee. Action with regard to the other cases is yet to reach a final stage. The reasons adduced by the Institute of Chartered Accountants for tardy progress was non-cooperation of witnesses and lack of evidence from the RBI. The Committee were informed that the Institute had approached RBI/SEBI and various levels in the Govt. for collecting the necessary evidence and, after exhausting all avenues, the Disciplinary Committee took a decision to approach the RBI to cooperate lest the Institute be constrained to take recourse to the provisions of section 21(8) of the Chartered Accountants Act, 1949 which empowers Disciplinary Committee for ensuring discovery and production of documents and attendance of witnesses. It was also clarified that according to the Act and the Regulations framed thereunder, the powers stipulated under section 21(8) are available only from the stage where cases are referred to the Disciplinary Committee for enquiry. Prior to that stage i.e. during *pre-prima facie* stage, such power has not been vested with the Institute and, as a result, difficulties are experienced in obtaining required documents in time. It was also stated that the provisions under the existing legislation are too cumbersome for taking expeditious action since a reference has also to be made to the High Court. Way back in the year 1994, the Institute had sent a comprehensive proposal to Government for amending the provisions of the Act.

**10.11 The Committee regret that the said proposals were kept pending by the Central Government despite repeated attempts at all levels to get this considered. Ultimately, in October 2001 Government asked the Institute to have a re-look at the proposals. The Institute has since reviewed the recommendations afresh and would submit the same to the Government. The Committee stress that the amendments if carried out, will not only reduce the time taken in disciplinary proceedings considerably but would also ensure effective and expeditious disposal.**

## **GUIDELINES ON CALL MONEY**

10.12 The banks were allowed, till April 2001, to both lend and borrow in the call/notice money market. With a view to reducing their excessive reliance on call/notice money market, the following guidelines on reliance on call money/notice money were issued in the Monetary and Credit Policy for the year 2002-03:—

- (i) Lendings of scheduled commercial banks in the call money/notice money market, on a fortnightly average basis, should not exceed 25% of their owned funds (paid-up capital plus reserves) as at the end of March of the previous financial year.
- (ii) Borrowings by scheduled commercial banks in call/notice money market, on a fortnightly average basis, should not exceed 150% of their owned funds or 2.0% of aggregate deposits as at the end of March of the previous financial year, whichever is higher.
- (iii) In order to ensure that scheduled commercial banks do not face any disruption in their ALM in adjusting to this stipulation, the existing borrowers and lenders should unwind their positions in excess of the prudential limits by the end of August 2002.

## **NOMINEE DIRECTORS:**

10.13 RBI has a system of placing its officers as its nominated Directors on the Boards of public sector banks. These nominee Directors serve as the source of first hand information to enable RBI to take necessary remedial action in cases of serious nature. The nominees usually report through a bi-monthly reporting system and are consulted while taking up on-site Inspection of banks. However, during the course of his examination, the Governor RBI informed the Committee that RBI representative should not be on the Boards of financial institutions including public sector banks owing to the conflict of interest involved between the RBI's supervisory and participatory functions. He further informed the Committee that they have already proposed to the Government to amend the legislation so that RBI representatives should not be placed on the Boards of the public sector banks. In regard to private sector banks, they have already removed all the RBI nominee Directors so that RBI continues to be the regulatory and monitoring authority, but not a part of the decision-making process.

**10.14 The Committee regret that although clear guidelines were laid down about the functions of the nominee-Directors, these duties were often not taken seriously or conscientiously, as illustrated in the case of the Nedungadi Bank. This is, perhaps, because of the inherent contradictions, to which RBI has drawn the attention of the Committee, between the regulatory and participatory functions of RBI in relation to the Banks. The Committee agree with the RBI that the concept of nominee-Directors needs re-examination. The Committee conclude that the lapses on the part of the RBI nominee-Director cannot be condoned despite the opinion of the RBI to the contrary.**

## **ACCOUNTABILITY**

10.15 With a view to strengthening the system of accountability in the banks, the RBI has instructed banks to appoint compliance officers to ensure compliance with all instructions/directives/guidelines issued by RBI/Government. Moreover, the compliance in respect of key areas is to be verified by the statutory auditors and the same is furnished to the RBI. The banks have also been advised to introduce a system of fixing accountability of the inspectors for any failure to bring out serious lapses detected subsequently and relating to the period covered under inspection.

## EXPOSURE TO CAPITAL MARKET

10.16 The commercial banks are permitted to invest in shares and debentures of corporates and grant advances against shares in terms of the provisions of the Banking Regulation Act, 1949. The bank's exposure in capital market takes the form of:-

- (i) Investment in shares, convertible debentures and units of equity oriented funds where the banks take the price fluctuation upon themselves;
- (ii) Advances against shares, which are subject to market risk but covered by margin requirements;
- (iii) Non-fund based facilities like guarantees, where credit risk arises on account of non-performance of the obligation.

10.17 In terms of the guidelines issued by RBI to banks in November 2000, a bank's exposure to the capital market by way of investment in shares, convertible debentures and units of mutual funds should not exceed 5% of the bank's domestic advances as on March 31, of the previous year.

10.18 It was not considered necessary to prescribe an overall ceiling for advances against shares and the issue of guarantees by a bank since shares are taken as security/collateral which are subject to mark-to-market discipline and, therefore, volatility in the asset prices in the stock market would not affect the value of the asset. The Board of Directors of each bank was, therefore, given the authority to lay down the ceiling for total advances against shares.

10.19 In terms of the guidelines relating to IPO financing, it has been laid down that the maximum amount of finance that can be granted to an individual for IPO should be Rs.10 lakh with a minimum margin of 25% against dematerialized shares and 50% against physical shares.

10.20 On being asked why no limit was fixed in the guidelines for the advances, the representative of RBI while deposing before the Committee stated as under:-

"Prior to the November 2000 guidelines, the banks could invest in the shares of a company up to 5% of their incremental deposits. At that time, the advance portion (*i.e.* advances against shares) was not taken into account in calculating that five per cent. Banks have got a freedom to give any amount of advance to the brokers and entities like that upto May 2001. When we brought the November 2000 circular, the reason why we have not included both investment and advances in the five per cent is that we should not put too many restrictions on the bank's lending to the stock market, otherwise the flow of funds would be restricted."

10.21 The Reserve Bank of India has furnished to the Committee, data from all commercial banks on their exposure to the capital market by way of investment in equity shares as also advances against shares. The exposure of commercial banks by way of investment in shares, as reported by banks was 2.19% and 2.11% at the end of 31.3.2000 & 2001 respectively. The data revealed that the exposure of public sector banks and old private sector banks was low and moderate and well within the norm of 5 per cent of the domestic credit stipulated in the RBI guidelines. However, the review also revealed that during the first half of year 2000, the exposure of four new private sector banks (Global Trust Bank, Centurion Bank, HDFC Bank and Bank of Punjab) was comparatively higher. Over the year 31.3.2000 to 31.3.2001, the total advances (*i.e.* fund based) granted against shares by scheduled commercial banks aggregated Rs. 3,269 crore as on 31.3.2001 as against 4,908 crore as on 31.3.2000.

## 10.22 Action Taken:

### (a) Action against specific banks for breaching the ceiling for investment:

- (i) The data on exposure to capital market collected by RBI from all the commercial banks revealed that as on 31.1.2001, three banks viz. Karnataka Bank Ltd. Rs.144 crore (5.87%), Bank of America Rs. 171 crore (5.04%) and Development Credit Bank Ltd. Rs.138 crore (8.29%) had exceeded the ceiling of 5 per cent for investment in equity shares.
- (ii) The explanation of these banks was called. Since the excess exposure in the case of Karnataka Bank Ltd. and Bank of America was marginal, no action was taken. These Banks have since brought their investment within the ceiling as on 31.3.2001. In the case of Development Credit Bank Ltd., it had exceeded the ceiling on account of an investment of Rs.80 crore in units of the Monthly Income Plan of UTI which it had treated as investment in debt funds and not as investment in equity. The Reserve Bank of India did not accept the bank's contention and it was asked to bring the investment within the stipulated ceiling. The bank's investment in equity shares as on 21.5.2001 amounted to 3.93% of its outstanding credit as on 31.3.2001.

### (b) Action against specific banks which had high exposure:

#### HDFC Bank, Bank of Punjab Ltd., Centurion Bank and Bank of Madura Ltd.

- (i) Although Reserve Bank of India had not prescribed any ceiling for total advances against shares by a bank and had given the authority to the Board of Directors of each bank to fix the ceiling for total advances against shares including issues of guarantees on behalf of brokers, a review made by RBI during the first half of year 2000, revealed that the exposure to capital market including advances, guarantees and financing of IPOs of four banks (Global Trust Bank Ltd., HDFC Bank Ltd., Bank of Punjab Ltd. and Centurion Bank Ltd.) was on the high side. Subsequently, it was found that the Bank of Madura Ltd. (Since merged with ICICI Bank Ltd.) had granted IPO financing for large amounts. Show cause notices were issued to the four banks (HDFC Bank Ltd., Bank of Punjab Ltd., Centurion Bank Ltd. and Bank of Madura Ltd.) for financing of IPOs asking the banks the reasons as to why monetary penalty should not be imposed.
- (ii) The Banks had submitted that financing of IPOs cannot be construed as loans against shares since at the financing stage there are no shares at all. The bank's were of the view that the existing instructions did not specifically prohibit bank's financing IPOs. The explanation submitted by banks was examined and a view was taken that since the guidelines were not very specific, it was not proper to impose any penalty. The four banks were, however, conveyed the displeasure of the Reserve Bank of India. Clear instructions were also provided to banks in regard to financing of IPOs *vide* the circular of 10/11/2000, clarifying that such financing can be extended only to individuals and not to corporates or NBFCs, subject to a maximum amount of Rs.10 lakh per individual.

(c) On the basis of reports appearing in sections of the press (which turned out be incorrect in important particulars), RBI requested SEBI on 24.11.2000 to inquire into the rise in GTB share prices and allegations of a single entity having acquired more than the permitted 5 per cent of the Bank's share holding. RBI did not act in a similar manner when share prices were going up much faster of several other banks in the comparable period of time, not even of the Bank of Madura, whose share prices on the eve of its merger with ICICI Bank rose even higher than

those of GTB. Also, while the OCB accounts with GTB and selected other banks were investigated by RBI, this was not done in respect of several other banks holding OCB accounts. **The Committee recommend that there must be uniformity of regulation so that the impartiality of the Regulator is recognized by all.**

10.23 RBI issued revised guidelines on equity and investment in shares in May, 2001. As per the revised guidelines, the total exposure of a bank to capital market in all forms is subject to an overall ceiling of 5 per cent of the bank's total outstanding advances (including commercial paper) as on March 31, of the previous year.

The salient features of the revised guidelines in brief, are as under:

#### Ceiling on direct investments in shares

- Within the overall ceiling of 5 per cent for total exposure to capital market, investment in shares, convertible bonds and debentures etc. should not exceed 20% of its net worth.

#### Advances to individuals

- Maximum ceilings of advances to individuals fixed at Rs. 10 lakh against physical shares and Rs. 20 lakh against dematerialized shares.

#### Financing of IPOs

- Banks can extend finance for IPOs only to individuals upto a maximum of Rs. 10 lakh and not to corporates.

#### Avoidance of concentration to stock brokers

- In order to avoid any nexus emerging between inter-connected stock broking entities and banks, the Board of each bank should fix within the overall ceiling of 5 per cent, sub-ceilings for total advance to all the stock brokers and market makers and also to any single stock-broking entity, including its associates/ inter-connected companies.

#### Margins

- Uniform margin of 40 per cent with minimum cash margin of 20 per cent (within the margin of 40 per cent) has been prescribed on all advances/financing of IPOs/ including issue of guarantees.

#### Financing of Arbitrage operations

- Banks have been prohibited from undertaking arbitrage operations or undertaking any sale transactions without actually having shares in their investment account.

#### Risk Management & Internal Control

- Banks are required to formulate a transparent policy and procedure for investment in shares by an Investment Committee to be held accountable with the approval of their Boards.
- The decision in regard to direct investment in shares should be taken by the Investment Committee which will be held accountable.
- There should be clear segregation of functional responsibilities.
- Surveillance and monitoring of investments in shares/advances against shares to be done by Audit committee of the Board.
- Equity shares in the bank's portfolio should be marked to market preferably on daily basis, but at least on weekly basis.

10.24 The monitoring of the exposure of the banks to the capital market *vis-a-vis* the guidelines prescribed by the regulatory department is being done by the Department of Banking Supervision through on-site and off-site inspections. There is a standing RBI-SEBI Technical Committee consisting of the Executive Directors of both the institutions. This committee meets on a half-yearly basis and reviews the overall position of the exposure of banks to capital market. Based on the market trends the committee gives its recommendations for any change in existing policies. Based on the recommendations of the Technical Committee, the Reserve Bank of India finalizes the policy in this regard.

#### **DIVERSION OF FUNDS AND THEIR END USE**

10.25 During its examination, the Committee came across cases where loans sanctioned by some private sector banks and Financial Institutions were diverted by the borrowing entities. Moreover, no credit appraisal system was followed by the banks while sanctioning the loans. On being asked about the extant legal provisions in this regard, RBI informed the Committee in a note that the Banking Regulation Act, 1949 does not include any provision as to the rights and responsibilities of borrowers or depositors. These are governed by the agreements, contracts and other documents entered into between the banks and their customers. As per the opinion given by the Legal Department of the RBI, in case funds are diverted, the action has to be considered as per the provisions of the Contract Act for civil remedy and as per the Indian Penal Code, 1860 for penal recourse, if any. The act of the borrower of fund is not governed by the provisions of the Banking Regulation Act, 1949. Criminal law rests on the principle of *mens-rea* which requires the proof of certain degree of *malafide* intention at the time of commission of the alleged crime (dishonest intention, fraudulent intention). To consider as to whether or not diversion of fund could be treated as an offence punishable under IPC, consideration of provisions of sections 405 and 415 of the IPC relating to criminal breach of trust and cheating is relevant. As per the judicial interpretation of implications of diversion of fund *vis-a-vis* provisions of Section 405, the Courts have observed that, "If a sum of money is advanced by way of loan no criminal breach of trust is committed even if the borrower uses it for a purpose other than that for which the advance was made".

10.26 As regards the offence of cheating as provided under section 415 of IPC, the Committee were informed that in order to make out an offence of cheating, the presence of dishonest intention from the beginning is necessary. In case of borrowing of funds from the bank, the proposal submitted before the bank clearly shows the purpose of borrowing. It is only at the subsequent stage that the borrowed funds are utilized for some other purpose. Thus it would be difficult to prove the presence of dishonest intention on the part of the borrower from the beginning and in the absence of such proof the offence of cheating as provided under section 415 of IPC cannot be made out. Therefore, unless the provisions of IPC are suitably amended as to make such acts on the part of borrowers as an offence punishable under IPC, there is no recourse available for penalizing the borrowers.

10.27 RBI informed the Committee that as per the existing RBI guidelines, it is the responsibility of the lending bank to ensure the proper end-use of funds by periodical monitoring borrowal accounts. RBI has issued instructions to banks to ensure that drawals from cash credit/overdraft accounts are strictly for the purposes for which the credit limits were sanctioned by them. There should be no diversion of working capital finance for acquisition of fixed assets, investments in associate companies/subsidiaries, acquisition of shares, debentures, units of UTI or other Mutual Funds and other investments in the capital markets. It has further been stated that many borrowers avail of finances from more than one bank and financial institution. Since funds are fungible and the borrowers maintain multiple accounts with several banks, it is often difficult to conclusively

establish specific linkages between the movement of funds in different accounts and the utilization of those funds for different purposes, particularly if the purpose for which a specific credit was granted was also being fulfilled as per the agreement between the borrower and the bank. While elaborating further, the representative of the RBI stated:

“Regarding the diversion question, it is like this. The funds are given by the bank to their clients or borrowers and it is the primary responsibility of the bank to ensure that the funds are used for the purpose for which it was taken, and if there is diversion by any client, primarily the bank should find out and then take appropriate action. The second layer is, when we go for inspection and we go through the records and we find that there is very blatant diversion of funds, then we question the bank and we question the Chief Executive Officer of the Bank and take necessary action.”

10.28 On further being asked as to how despite the annual inspections in the case of GTB the funds got diverted and why no action was taken by RBI, the representative of RBI stated:

“We conducted these inspections. We came to know that there are diversions in respect of seven companies. If you look at the earlier reports of 1997 and 1998, these diversions were not in this magnitude. Only during 2001, it started. Because of this only, all these problems happened. We did take action.”

10.29 RBI also informed the Committee that steps have been taken to disseminate information on the defaulters of the banks, and FIs and for the publication of ‘suit filed accounts’ (Rs. one crore and above) and ‘suit filed cases’ of wilful default of Rs. 25 lakh and above. These have been circulated for the period up to 31.3.2000 and placed on the RBI website. An amendment to section 28 of the BR Act, 1949 for inserting an enabling provision to allow RBI/NABARD to publish information in the public interest is under consideration.

10.30 The Committee were further informed that in pursuance of the recommendations of the Standing Committee on Finance, a Working Group under the Chairmanship of the IBA Chairman, Shri Kohli was constituted in May, 2001 to look into the issue of the diversion of funds. The Working Group submitted its Report in November 2001. When asked as to whether the RBI did not have any idea of large scale diversions taking place before the Report of the Standing Committee, the Governor RBI was candid to admit, “I think you are quite right that the system, as it exists today, is not effective in preventing diversion of funds.”

**10.31 The Committee regret that knowing fully well the ineffectiveness of the extant system in preventing the diversion of funds, RBI should not have taken before the scam broke the steps they have so assiduously put in motion after the scam. The Committee stress that a good Regulator would have anticipated the possibility of diversion of funds and taken preemptive action to forestall it. It is not good regulation to wait for a loophole to be exploited before closing it.**

10.32 The Kohli Working Group in their Report have elaborately dealt with the issue of the diversion of funds, including the punishment that should be given to such borrowers, and various methods which should be adopted to this end such as meaningful scrutiny of quarterly progress reports/operating statements/balance sheets of the borrowers; regular inspection of the borrowers’ assets charged to the lenders as security; periodical scrutiny of the borrowers books of accounts and non-lien accounts maintained with other banks; periodical visits to assisted units; system of

periodical stock audit, etc. with a view to ensuring that funds are not misutilized. The definition of 'wilful default' has also been given in this report and it has been suggested that the following measures be initiated against wilful defaulters:-

- (a) The names of defaulters, along with the names of full-time senior executives of the entity, should be disclosed. RBI may collect the information from banks and FIs and circulate the same to all banks and notified FIs.
- (b) A copy of the aforesaid list should be forwarded to SEBI with a view to preventing the borrowers' access to domestic capital markets.
- (c) No additional facility should be granted by any bank/FI to listed wilful defaulters.
- (d) The guarantors of defaulting borrowers should also be made liable for loss caused to the banks and FIs.
- (e) Legal process, wherever warranted, against the borrowers, guarantors and foreclosure to recover the dues, should be initiated.
- (f) Statutory amendments should be initiated to empower banks and FIs to attach the assets charged to them as security directly *i.e.* without the intervention of the Courts of law, after serving due notice to the borrowers, in case of wilful default.
- (g) Change of management of the defaulting borrowing unit, wherever possible, should be brought about.

10.33 The Group also examined in detail the desirability, efficacy and practicability of the following penal measures against the defaulters/other borrowers/guarantors:-

- (i) debarring from institutional finance from public sector commercial banks, DFIs, Government owned NBFCs, investment institutions etc, for floating new ventures for a specified period, the promoters of companies which have resorted to siphoning of funds, misrepresentation, falsification of accounts and fraudulent transactions;
- (ii) debarring from institutional finance for a specified period, the entrepreneurs who deliberately did not honour the invoked guarantees despite their having the capacity to honour them;
- (iii) debarring promoters who have diverted funds from institutional finance for a specified period for starting new ventures;
- (iv) filing of criminal cases against wilful defaulters and those who resort to the siphoning of funds, misrepresentation, falsification of accounts and fraudulent transactions;
- (v) adopting a proactive approach of the DFIs for changing the management of companies which have diverted funds;
- (vi) ensuring removal from the Board of companies, in which DFIs have substantial equity stake, of those directors of other companies which have diverted funds.

10.34 The Group after deliberation came to the conclusion that all the above mentioned measures (except filing of criminal cases) should be adopted to deal with the defaulters effectively. As regards filing of criminal cases against wilful defaulters by the banks/FIs, the Group was of the view that the prime concern of the lenders was recovery of dues from the borrowers and filing of criminal cases against the defaulters would not necessarily lead to such recovery, for which a separate 'money suit' would also need to be filed simultaneously. This

would cause an avoidable burden on the lending institutions without commensurate benefits to them. The Group further opined that criminal proceedings against wilful defaulter could be initiated selectively and not as a matter of routine, at the discretion of the lenders, keeping in view the severity of the wilful default. The Group has also recommended that the aforesaid debarment of borrowers for availing institutional finance in so far as banks are concerned should not be confined to the debarment from the public sector banks alone but should extend to all scheduled commercial banks (excluding Regional Rural Banks). To begin with, the debarment of borrowers/promoters from institutional finance might be made for an initial period of five years, which could be reviewed thereafter in the light of the experience gained. However, it should be ensured that a transparent mechanism is put in place so that such provisions were not misused and the scope of such discretionary powers was kept to the barest minimum.

10.35 The RBI while submitting written replies in the matter has stated that the recommendations of the Kohli Committee have been examined by an In-house Group of RBI and the recommendations have since been adopted with changes in the definition of wilful defaulters. The RBI has also issued the circular on 30.5.2002. The circular deals with (i) Definition of wilful default, diversion and siphoning of funds; (ii) provides for cut off limits of Rs. 25 lakhs for wilful defaulters; (iii) end use of funds; (iv) penal measures include denial of additional facilities by banks/FIs for 5 years, initiation of criminal proceedings, etc.; (v) complaints to be lodged by banks/FIs with ICAI against negligent auditors or deficiencies in conduct of audit; and (vi) Banks/FIs to compile a list of wilful defaulters for submission to RBI. (The full text/details of the circular of 30.5.2002 are at Appendix X)

**10.36 The Committee recommend that RBI should constantly review the feasibility of implementing these guidelines.**

10.37 On the question of absence of fear in the mind of persons involved in the diversion of funds and exploring the possibility of the criminal action apart from penal actions suggested by the Kohli Committee and of obtaining a certificate from the borrower by the Bank certifying that the funds have been used for the purpose for which they have been borrowed, the Governor, RBI stated as under:-

“Both your points are acceptable. One is that there should be certification, there should be watchfulness on the part of the bank. We would see as to how it could be found. There is a concurrent monitoring. Secondly, if there is either a false representation or an established wilful misuse of funds, then there should be criminal action”.

**10.38 While the Committee commend the action taken after the scam came to light, it regrets that timely action on these matters was not taken much earlier as such pre-emptive action could have forestalled, or at least moderated, such diversion.**

#### **EXISTING VIGILANCE MECHANISM IN BANKS**

10.39 In view of certain irregularities which surfaced before the Committee in the case of the banks, the Committee wanted to know regarding the efficacy of the vigilance mechanism which is prevalent in the banks. They were informed in a separate note submitted by the RBI that in terms of para 3 of the Government of India's Vigilance Manual, Chief Vigilance officers are appointed in the Ministries/Departments, Public Sector Undertakings and Nationalised Banks after prior consultation with the Central Vigilance Commission (CVC). The CVC acts as an apex body for exercising general superintendence and control over vigilance matters in administration and probity in public life.

10.40 The Chief Vigilance Officers in the Public Sector Banks are generally appointed from other banks/RBI, etc.. The Chief Vigilance Officer functions independently and reports directly to the Chief Executive of the bank under the overall control of the CVC. Investigations are carried out by the Vigilance Department on the basis of irregularities, etc. pointed out in the internal audit/inspection reports, information relating to failure of internal control system, complaints received from different quarters etc. In Public Sector banks there is a system of preparing a list of officials of doubtful integrity and keeping surveillance on them with a view of preventing frauds. In the case of private sector banks including foreign banks, there is a system of vigilance arrangement which is generally with the audit and Inspection Department. They also have a system of generating Exception Report on critical areas of banks functioning based on which the inspection and Audit Department carries out necessary investigation, etc.

## **B. Urban Co-operative Banks**

10.41 The regulation and supervision of the Urban Co-operative Banks (UCBs) is exercised by Urban Banks Department of the Reserve Bank of India through its Central Office at Mumbai and its 16 Regional Offices. The Urban Banks Department performs the following three functions in overseeing the activities of UCBs. These are:

(a) Regulatory (b) Supervisory (c) Developmental.

10.42 In line with the reforms brought in by RBI for commercial banks and also the recommendations of the High Power Committee (HPC) on Urban Co-operative Banks (UCBs) constituted by the Reserve Bank of India in 1999, similar reforms have also been initiated by the Reserve Bank of India for the Urban Cooperative Banking Sector as are applicable to commercial banks:

### **I. Application of prudential norms**

In 1993, RBI introduced income recognition and asset classification norms. In 1996, the prudential exposure ceiling to a single party and to groups to lend not more than 20% of their capital funds to single party and 50% to a connected group was introduced. From 31.3.2002, Capital to Risk Assets Ratio (CRAR) norms have been made applicable to UCBs in a phased manner. Well managed UCBs are allowed to extend their area of operation to the entire State and UCBs owning funds of not less than Rs. 50 crore are permitted to operate beyond the State in which they are located.

### **II. New Licensing policy**

The HPC also examined the licensing policy of UCBs and suggested a significant hike in the Entry Point Norms (EPN). The revised policy has been put in place with effect from August 2000.

### **III. Restructuring / revival of weak UCBs**

The existence of a large number of weak UCBs (249 banks) has become a cause of concern for RBI. The HPC examined sickness in the Urban Co-operative Banks and recommended the classification of unhealthy banks into weak and sick categories on the basis of levels of CRAR, net NPAs and history of losses.

### **IV. Recent Monetary Policy measures**

Urban Co-operative banks were until 19.4.2001 permitted to lend against pledge of shares only to individuals upto Rs. 10 lakh if the shares were in physical form and upto Rs. 20 lakh if

they were in the demat form. UCBs were prohibited from extending any financial assistance to stock brokers. In the backdrop of disturbing trends exhibited in the Urban Co-operative Banking sector in the recent past, certain regulatory norms were announced in the monetary policy announced in April 2001 to safeguard depositors' interests. The following is the gist of these measures:

**“(a) Prohibiting UCBs from lending against shares, etc.**

UCBs have been debarred from extending any loans against pledge of shares/debentures, etc. They have also been advised to unwind their existing exposure to the capital markets by the due dates. They have also been prohibited from granting advances for the financing of Initial Public Offerings (IPOs)

**(b) Exposure to call money markets**

In order to reduce excessive reliance on call money market, UCBs borrowings on any day should not exceed 2% of their aggregate deposits as at the end of previous financial year.

**(c ) Ban on interlocking of UCBs' deposits**

As parking of funds by UCBs with other UCBs pose a systemic risk, which has been exemplified in the Madhavpura Bank crisis, as a safety precaution, UCBs have been prohibited from parking their funds with other UCBs in term deposits. The existing balances would be unwound by end of June 2002.

**(d) SLR investments**

All UCBs also are now required to invest a proportion (in the range of 10% - 20%) of their Statutory Liquid Ratio (SLR) in Government Securities.

**(e) Application of ALM guidelines**

A working Group has also been constituted to suggest Asset-Liability Management guidelines for UCBs keeping in view their structure, clientele etc. These proposals are under discussion with the Govt. of India.”

**10.43 The Committee commend these constructive steps and only regret that they were not taken earlier. The Committee recommend that RBI should constantly review the feasibility of implementing these guidelines.**

## **INSPECTIONS**

10.44 With the phenomenal increase in the size of balance sheets and the volume of operations of scheduled UCBs in particular and other UCBs in general, the Reserve Bank had revamped its inspection systems and procedures in line with that of commercial banks in 1999. Under the revised scheme, the weak banks were subjected to annual inspection. The thrust of revised inspection system was on assessing the networth of the bank, evaluating management conduct, earning capacity, liquidity, etc. The periodicity of inspection of scheduled urban cooperative banks (UCBs) other than weak UCBs was once in two years, prior to 11.6.2001. After the failure of the Madhavpura Mercantile Cooperative Bank Ltd., (MMCB), Ahmedabad, the periodicity was made once a year for all scheduled UCBs, including weak UCBs.

10.45 The common major defects observed in the working of urban cooperative banks, as revealed by the inspection reports of the Reserve Bank, include (i) inadequate scrutiny of loan applications with reference to the purpose, credit-worthiness of the borrower and operations of earlier loan accounts; (ii) failure to take adequate safeguards while granting loans against immovable property, merchandise, and gold and silver ornaments in regard to verification of stocks, etc; (iii) sanction of surety loans; (iv) failure to take prompt action against defaulters; (v) deficits in the maintenance of CRR and liquid assets, or prevalence of large surplus liquid assets, and (vi) unsatisfactory maintenance of books of account and inadequacy of internal checks, etc.

10.46 Important findings of the inspections of scheduled urban cooperative banks are discussed with the Chairman, CEO and a few directors by the Chief General Manager, Central Office at Mumbai after the issue of the inspection report. In the case of weak banks and unlicensed banks, such meetings are convened by those in-charge of Regional Offices. Such meetings are also utilized for the collection of the market intelligence reports on activities of various urban cooperative banks in the area of operation of the bank called for discussion. In the case of scheduled UCBs registered under the Multi-State Cooperative Societies Act, 1984, such meetings are called by the Regional Director/General Manager-in-Charge (Chief General Manager in the case of the Mumbai Regional Office).

10.47 Based on the findings of the inspections, specific directions are issued to UCBs on operational matters relating to incurring fresh liabilities, grant of loans and advances, repayment of deposits, etc. depending on the gravity of each case.

10.48 When it is found in an inspection that the affairs of an UCB have been carried out in a manner detrimental to the interests of the depositors, the Reserve Bank of India is empowered under Section 35A of the Banking Regulation Act, 1949, to issue such directions to an UCB as it deems fit. Under Section 22 (4) (iii), the Reserve Bank of India is also empowered to cancel the licence of an UCB.

## **REVAMPING THE AUDIT SYSTEMS**

10.49 At present audit of UCBs is conducted by the auditors of State Governments, who lack expertise. The expert panel appointed by RBI in 1995 suggested professionalisation of audit, empanelment of Chartered Accountants and concurrent audit for large sized UCBs, as well as a uniform audit format for all States. RBI accepted these recommendations and advised the State Governments to implement. It is a matter of regret that some State Governments have not implemented despite lapse of 5 years. Recent happenings in the cooperative sector warrant entrustment of audit to Chartered Accountants to have proper control over them and to fix accountability by the Institute of Chartered Accountants of India. The RBI has accordingly proposed an amendment in the Banking Regulation Act, 1949 to extend the application of Section 30 to Cooperative Banks.

**10.50 The Committee note that this step should have been taken earlier had the regulator been alert.**

## **CAPITAL EXPOSURE**

10.51 A review by the RBI of the recent developments has revealed that there has been inadequacy in the supervision and control mechanisms over Urban Cooperative Banks. As on 31.3.2001, there were 2084 UCBs in the country. The Committee during the course of examination found that Madhavpura Mercantile Cooperative Bank Ltd., Ahemdabad, and City Cooperative

Bank Ltd., Lucknow had lent sizeable funds to share/stock brokers in gross violation of the RBI guidelines. Apart from these banks, the Classic Cooperative Bank Ltd., had extended advances against shares to 60 borrowers for public issue of Cinevista, Rs. 38 lakh each in violation of RBI guidelines on advances against shares. Similarly Janta Sehkari Bank Pune advanced 110 guarantees worth Rs. 56.88 crore to brokers.

10.52 The Committee enquired about the prevalent guidelines regarding capital exposure in the case of UCBs and were informed that UCBs are not permitted to have direct exposure to the stock market. However, UCBs are permitted to invest surplus funds upto 10% of their deposits in bonds and equity of All India Financial Institutions (AIFI) and bonds of Public Sector Undertakings (including infrastructure bonds, Tier II Capital Bonds of Public Sector banks). UCBs are also permitted to invest upto 5% of their incremental deposits over the previous year in units of UTI within the 10% ceiling as above. UCBs were allowed till recently to grant loans against security of shares to individuals only upto certain limits.

10.53 The Reserve Bank of India had collected data on exposure to the capital market by way of investment in bonds/shares as also advances against shares from all UCBs. The total exposure of 1746 UCBs to the capital market by way of investments in bonds/shares of the banks aggregated Rs. 2693.39 crore as on 31.3.2001; of which investment in shares of companies stood at Rs. 1.63 crore forming 0.1% of total investment. The advances granted by UCBs against shares/debentures to individuals aggregated Rs.123.35 crore as on 31.3.2001 (excluding advances granted by Madhavpura Mercantile Co-operative Bank Ltd, Ahmedabad). The RBI has informed that in 57 cases, it was found that UCBs had invested Rs.1 lakh to Rs.32.50 lakh in shares of companies other than AIFIs. Such banks have been advised to divest these holdings before 30.6.2001.

10.54 The representative of RBI during the course of his evidence before the Committee submitted:—

“.... actually our guidelines are that UCBs are not allowed to grant advances to the stock brokers. These guidelines were issued in 1998. .... 25 banks had given advances to stock brokers. As compared to the total exposure of 25 banks, the bulk of the total advances worth Rs.1100 crore was given by the MMCB. The advances given by the remaining 23 banks are comparatively small”.

10.55 On being asked as to why RBI did not take action against such UCBs, the Governor RBI stated:

“If there is a violation, which is marginal, which is small and which is not fraudulent and it is either because of misrepresentation or because of wrong doing on the part of somebody, the idea is to give the notice to the bank and ask them to bring it back to normal within a reasonable period, to allow for sometime so that the public does not get scared. There is no run on the bank.”

Another representative added:

“We have instituted a system of off-site surveillance which would capture these things. Actually there is a system of quarterly returns which the banks would be required to submit. This stipulated that the banks would have to submit quarterly returns. But this thing has happened before that. In all these cases we have called for the explanation.”

10.56 In view of the highly volatile nature of the capital market and the UCBs who hold deposits of small and middle income groups and do not have the required expertise to deal in the stock market, the Reserve Bank of India has decided to prohibit these banks from granting any financial assistance against security of shares and debentures effective from 19.4.2001. Further, Reserve Bank of India has advised those UCBs who have violated the guidelines specified and invested in the bonds/shares of corporates, companies floated by All India Financial Institutions and units other than UTI to divest such holding on or before 30.6.2001.

10.57 The RBI has also introduced an off-site surveillance system for Scheduled UCBs for closer supervision of their activities. Under the said system, scheduled UCBs are required to submit returns in prescribed forms at quarterly intervals with reference to their financial position as on March 31, June 30, September 30 and December 31 in a given financial year. The off-site surveillance system will involve monitoring the activities of such large banks on an on-going basis and it will supplement the present system of on site inspection carried out under section 35 of the Banking Regulation Act, 1949 (As Applicable to Cooperative Societies). The off-site surveillance system combined with on-site inspection will help the Reserve Bank of India in ensuring the safety of investors' funds. Further, the Urban Banks Department is following a system of periodical visits of Regional Heads or Officers deputed by them to UCBs under their jurisdiction.

**10.58 These measures taken by the Reserve Bank of India will help in effectively supervising the activities of UCBs and discovering frauds if any, committed by them. It is inexplicable why these measures were not taken earlier, especially given the huge increase in the number of UCBs, the huge size of their deposits and their increasing involvement, overtly and covertly, in stock market operations well before the scam.**

#### **Dual control over urban cooperative banks**

10.59 At present, under the existing regulatory/supervisory framework for UCBs, three authorities are involved — the Reserve Bank of India, the State Government and the Central Government (in case of multi-State UCBs). The UCBs primarily being co-operatives societies, are governed by various provisions of the State Co-operative Societies Act, apart from the Banking Regulation Act, 1949 AACS (As applicable to Co-operative Societies). The powers in regard to incorporation, registration, management, amalgamation, reconstruction, supersession or liquidation of UCBs are exercised by the Registrar of Co-operative Societies of the State concerned, under the respective Co-operative Societies Act. In the case of the UCBs coming under the purview of the Multi-State Co-operative Societies Act, such powers are exercised by the Central Registrar of Co-operative Societies. The functions of UCBs relating to banking, such as issue of branch licence, loan policies, investments, prudential exposure norms etc. are regulated and supervised by the RBI under the provisions of the Banking Regulation Act, 1949. The Committee were informed that very often the multiplicity of the agencies involved results in overlapping jurisdiction and difficulties in carrying out administrative/prudential measures effectively. At times conflicting directions are issued hampering the working of the UCBs. The Committee found that in one case, the RBI had forwarded a complaint to the Joint Registrar of Co-operative societies, Gujarat after substantiating the charges, but no action was taken since the Joint Registrar had stated that there was no substance found in the complaint. On being asked as to how such issues should be resolved, the representative of the RBI stated:

“There is the case of Gujarat which you referred to. There are other matters. For instance, when we find that the bank is beyond redemption, we have got the authority to send a requisition to the Registrar to take the bank under liquidation. There have been many cases, where the Registrars have not acted on our requisitions.”

10.60 The supervision of 2090 UCBs of which, 54 are scheduled banks, in view of the large number as well as their dispersed and local character, pose serious problems. The Governor RBI admitted during his deposition before the Committee, "the RBI as the Central Monetary Authority is also not well equipped to supervise 2000 small banks."

10.61 The RBI conducts statutory inspections normally once in 2 years in respect of non-scheduled UCBs, while the weak UCBs and scheduled UCBs are inspected on an annual basis. The managerial aspects of UCBs being with the State Governments, any supervisory action recommended by the RBI often involves delay in taking immediate remedial steps, because such remedial measures are eventually have to be implemented only by the State Governments. Giving his comments on the issue of dual control, the Governor, RBI in his deposition before the Committee submitted :—

"...I believe, that it is essentially a political question. There are two sides to it that the Cooperative are local institutions. You have cooperatives which are working in multiple States also. So, the involvement of the State Government, the local authorities as well as the Central Government in the regulation of the cooperative societies is essential. The view of the RBI has been that this does complicate, as you have rightly said, the structure of control and divide the responsibilities. One cannot pinpoint who is wrong and who is right. Even if the RBI finds something wrong on the banking side, it goes to the Regional Registrar of Cooperatives or the Central Registrar of Cooperatives who can then take a view which is not necessarily consistent with the purely technical or financial view which the RBI may take."

10.62 The High Power Committee on Urban Cooperative Banks (Madhava Rao Committee) felt that the dual control regime, per se, need not cause hindrance to the urban banking movement. The Committee had recommended that the only effective way to address the problem of dual control is to carry out amendments in the State Cooperative Societies Act, Multi-State Cooperative Societies Act, 1984 and also the Banking Regulation Act, 1949 (AACS) to clearly demarcate the banking related and other functions between the RBI and the Registrar of Cooperative Societies of the States concerned. The major recommendations of the Committee in relation to the RBI's powers over the UCBs, which involve legislative amendments, are as under:—

- (i) In case of UCBs, the audit should be conducted by a Chartered Accountant whose appointment should be approved by the RBI. For this suitable amendments should be made in the Banking Regulation Act, 1949 and in various Co-operative Societies Acts.
- (ii) Section 36AA of the Banking Regulation Act, 1949 may be extended to the UCBs so as to empower Reserve Bank to remove either one or more members of the Board or the Chief Executive Officer or some other officer of the UCBs.
- (iii) Certain provisions of Section 45 of the Banking Regulation Act, 1949 providing for the framing of a scheme of amalgamation/reconstruction should be extended to UCBs.

10.63 The RBI has since accepted most of the recommendations. The Committee were informed that the issue relating to the amendments to the State Co-operative Societies Acts as recommended by the High Powered Committee was in turn commended to the Government with a request to take up the matter with the State Governments concerned to promote necessary legislative amendments in this regard. The Ministry of Finance, however, advised RBI that it may be possible to bring UCBs under the discipline of RBI's regulatory and supervisory

regime by making suitable amendments in the Banking Regulation Act, 1949 irrespective of the provisions in the State Cooperative Societies Acts and Government would like to consult the Ministry of Law on the subject. Accordingly, the RBI has forwarded the amendments (Appendix-XI) to the Banking Regulation Act, 1949 to the Ministry of Finance for consideration. The Committee were informed that a draft cabinet note had also been submitted by the Ministry to the Cabinet Secretariat.

10.64 In view of the consequences of the present multiplicity of authorities involved in the regulation and supervision of the UCBs and other problems that have been observed, the RBI had mooted with the Government of India, a proposal to set up a separate Apex Supervisory Body which can take over from the RBI the entire inspection/supervisory function in relation to UCBs. The Apex Body could be under the control of a separate high-level supervisory board, consisting of representatives of the Central Government, the State Governments and the Reserve Bank of India as well as independent experts. The Apex Body could be charged with the responsibility of inspection and supervision of UCBs and ensure their conformity with the prudential regulatory requirements as also management norms laid down by the RBI.

10.65 Some of the specific provisions proposed in the draft Bill forwarded by the RBI to Central Government for setting up of the Apex Body are: (i) vesting the powers with the Apex Body for appointment of Chartered Accountants as auditors for the UCBs by moving amendments to the respective State enactments. (at present, audit function over co-operative banks is exercised by the State Governments), (ii) powers to appoint Chairman, Managing Director, etc, of a Multi-State Cooperative Bank, as also powers for removing persons holding managerial positions from office and to appoint additional directors, for these banks (iii) to order moratorium, to formulate scheme for amalgamation, and to apply for winding up of a Multi-State Co-operative Bank, etc.

10.66 The Apex Body, as per the proposal mooted by the RBI, will be vested with all the powers to exercise supervision over the UCBs. As co-operation is a State subject, the State Governments are to be associated with the Apex Body even in respect of the Multi-State Co-operative Banks. Each State Governments can suitably amend their respective Co-operative Societies Act or issue necessary notifications under these Acts to delegate the authority to the new Apex Body for carrying out the functions envisaged in the draft Bill.

10.67 The proposed Apex Body will substantially eliminate the problems arising from dual control over co-operative banks for the following reasons:

- (a) The Apex Body will have representatives of the State Governments, Central Government, the RBI, independent professionals connected with the cooperative movement and will, therefore, be able to take a more objective view about the performance and the consequent supervisory action against the bank without any procedural delays.
- (b) Under the existing supervisory framework, the Co-operative Department of the State Government is vested with powers to take management action against the UCBs. Since, the proposed Apex Body will be an independent expert body and not an arm of the State Government, it will be able to discharge its supervisory role more effectively and ensure compliance with regulatory norms free from any political interference.

10.68 The RBI stated that the Ministry of Finance, in a Draft Cabinet Note proposed amending the Banking Regulation Act, 1949 (Principal Act).

## LEGISLATIVE MEASURES PROPOSED FOR STRENGTHENING THE REGULATORY REGIME

10.69 The irregularities observed in 1992 pertained to interconnected transactions between brokers, public sector banks, foreign banks, FIs, co-operative banks and private sector banks. During the course of examination, the Committee were informed by RBI, that in pursuance of the recommendations made by the earlier Committee on securities scam (1992), the RBI had taken up a number of measures with regard to investment policy in Government securities, prohibition of certain transactions viz, Portfolio Management Scheme, restriction on ready forward transactions, streamlining the BRs, putting restrictions on brokers, strengthening the supervisory system in the case of Scheduled commercial banks and a host of other measures which have already been mentioned. The provisions of Chapters IIIB, IIIC and V of the Reserve Bank of India Act 1934 have been amended on 28.3.1997 empowering the RBI to exercise more effective control over Non-banking Financial Companies and prohibit acceptance of deposits by un-incorporated bodies.

10.70 Consequent to the number of irregularities recently noticed in the operations of some of the private as well as the co-operative banks, the RBI took a number of steps and issued revised guidelines thereby further regulating the operations of the banks. Most of these fresh measures have already been delineated. On being asked as to what pro-active role can the RBI play as an institution in unearthing the scam and ensuring that such scams do not recur in future, the Governor RBI stated:

“So far as the scam that you have unearthed is concerned, the most important role that Reserve Bank can play is greater transparency and better prudential regulations of the banking system so that the banks are not engaging in the kind of conspiracy or the activity that you are referring to.” While commenting on the deterrents that are available for punishing the wrong-doers, the Governor was candid to say, “But I would say that our system is weaker than any other system in any respectable democracy in punishing the people who are known to have engaged either in conspiracy or fraud and in the banking system particularly.”

10.71 On being asked whether RBI should be empowered with more investigative powers and vested with the kind of powers which police officers have for investigating the cases, the Governor stated that such powers are not enjoyed by any monetary authority/Central Bank and hence are not required. The RBI however stated in a note that there are certain areas in which through amendments in the Banking Regulation Act 1949, more powers should be vested with the RBI, as follows:—

- (i) Section 20:— Section 20 of the Act is proposed to be amended to further restrict a banking company from lending to “entities and persons connected to banking companies and or its Directors”. The objective is to prevent the siphoning off funds by the company and or its directors through front companies connected with them. The proposed amendment contemplates that a banking company cannot lend to other companies connected with the banking company as well as with its directors.
- (ii) Provision regarding change of management:— A new provision has been proposed to provide that any person who proposes to acquire 5% or more of shareholding of any banking company, either singularly or in concert with other parties, should obtain prior written permission of RBI.
- (iii) Power of RBI to supersede the board of a banking company:— A new provision to empower the RBI to supersede the board of a banking company, in case the board is found to be acting contrary to the norms or taking imprudent decisions which are likely to affect the health of the company has been proposed.

- (iv) Consolidation of accounts and consolidated supervision:— Sections 29(4),35 and 35(1A) of the Act are proposed to be amended under this head.
- (v) Prohibition regarding common directors:— Section 16(1) of the Act prohibits director of a banking company to be director of another banking company. It is proposed to debar directors of co-operative banks also from becoming directors of other banking companies.
- (vi) Applicability of Act to certain financial institutions:— A new chapter is proposed to be inserted after Part IIC, to be made applicable to IDBI, NHB, NABARD, EXIM Bank, ICICI, IFCI, IIBI etc. and such other institutions as may be specified by RBI. Under the proposed provisions, the financial institutions will be required to maintain CRR, SLR, take approval of RBI for appointment of statutory auditors and the RBI will have powers to inspect them, remove directors or appoint additional Directors on the Boards of these institutions.
- (vii) Protection from legal proceedings:— Section 54 of the Act gives protection to the RBI from legal proceedings for any action taken in good faith, but does not debar a civil court to grant injunction against the bank. It is therefore proposed that no civil court will have jurisdiction in respect of anything done or intended to be done, by or under this Act and no injunction shall be granted by any civil court or action taken by the RBI.

**10.72 The committee, however, deplore the tardiness exhibited in rectifying the shortcomings. Amendments to the existing legislation, submitted by RBI to Ministry of Finance on 30.10.2001, months after the scam broke, should have been proposed much earlier in the wake of the Action Taken Reports to strengthen the regulatory system. That these amendments had to wait for a second major scam to break reveal the petering out, within months of the ATRs, of the will of the Government to implement the required systemic changes.**

### **10.73 Other Issues**

(i) Financial Frauds:- On being asked as to what are the other steps which have been initiated particularly to stop/minimize financial frauds, the RBI informed the Committee in writing that in the year 1991, on the instructions of the then Finance Minister, the Ghosh Committee on Bank frauds was set up, which had given about 125 recommendations and out of these most of the recommendations were accepted by RBI. Subsequently, another Committee on bank frauds under the Chairmanship of Dr. N.L.Mitra was set up recently in Aug, 2000. The purpose of setting up this Committee was mainly to examine certain legal aspects including a definition of financial fraud and laying down procedural law to deal with such frauds. On being asked as to the status of implementation of the recommendations of this Committee, RBI informed the Committee that these consist of two parts-Part I dealing with recommendations which can be implemented without any legislative changes; and Part II requiring legislative changes. Recommendations under Part I which relate to development of best practice code, internal check and control, responsibility of RBI in frauds reported by the banks, which deal with preventive aspects of bank frauds, have already been accepted and operational instructions issued on 3.5.2002 for their implementation . Recommendations under Part II which relate to such issues as a separate Act to deal with financial fraud, the need to make these a criminal offence, special responsibility of the regulator, separate institution to investigate these, powers of search, seizure and attachment etc. are yet to be implemented.

It has also been stated by the RBI that if instructions/guidelines based on these recommendations are scrupulously followed by bank functionaries, all types of fraud, including those relating to the stock market could be prevented to a large extent.

(ii) Corporate Governance:-The Committee were also given to understand that an Advisory Group on Banking Supervision under the Chairmanship of Shri M.S.Verma was set up by the Government which submitted its Report in May 2001. The main recommendations of the Group can be broadly classified in seven categories, viz, (i) Corporate Governance;(ii) Internal Control; (iii) Risk Management; (iv) Loan Accounting; (v) Transparency and Disclosures; (vi) Financial Conglomerates; and (vii) Cross-border Banking Supervision.

(iii) Single Regulator:- On being asked whether RBI was in favour of a lead regulator, the Governor RBI stated:

“There are different views, as you know, international and in our country also. Different experts have opined in different ways. So, we do not have a definite view just now. But if you like to ask for my view, in my present capacity, I can give it. At the moment my view is that a single regulator, given the range of institutions that we have and given the different sizes of institutions that we have, will not be more effective. You have the corporate bodies, NBFCs, chit funds, plantations, commercial banks, private banks, public sector undertakings which are regulated by different statutory provisions, which are regulated by different traditions in our system, small, very local or multi-local. There are State and Central statutes. Then there are regulations of all kinds. Then, it is not within the institutional capacity, in my view, of a single regulator to regulate all this. Speaking for the RBI, I can say to this Committee that it could be counterproductive because it does not have the kind of network that would be required and the kind of expectation which our country has in regard to financial regulations.”

(iv) Technology Upgradation:- In view of the fact that the Narsimham Committee in their Report (Part II) of 1998 has emphasised the need for technology upgradation in the case of the Indian banks, the RBI was asked to state different steps taken in this regard. They have informed the Committee in writing that Bank automation has been achieved to a substantial extent. As far as Public Sector Banks are concerned, they have achieved computerisation of at least 70% of their business. While most of the other older banks have implemented technological upgradation as part of their business plans, the newer banks have IT as an integral component of their operations abinitio. Standardised inter-bank electronic platforms are now available in the form of the Electronic Clearing Service(ECS) and the RBI-Electronic Funds Transfer(EFT) Scheme and most banks have their own intra-bank system for transfer of funds electronically among their branches. For cheque truncation, amendments to the Negotiable Instruments Act, 1881 have been recommended by the Working Group which is now with the Government. A draft Payment Bill is being made for providing adequate legal basis for the payment system. Initiatives for setting up data warehouses at the industry level and at each bank have already commenced. The Committee on Technology Upgradation in the Banking Sector (1999) have already provided guidelines for an out sourcing policy. Efforts to have a Real Time Gross Settlement System have already been initiated and it is likely to be completed in a year or so.

(v) Flow of Funds:- The Committee were concerned to find out whether incoming and outgoing flow of funds into the entire financial system can be monitored. The Deputy Governor of RBI, while deposing in this regard stated:

“Finally, basically the issue is that in terms of the totality of fund flow to stock market and fund flow out, the Reserve Bank of India, in the role as monetary authority, is interested in the overall liquidity and as a regulator is interested in the functioning of the banking system, but not in the overall flow of funds to different activities in the financial markets. That is my submission. But if such a mandate is given we have to do that. But so far, to my knowledge we have no such mandate.”

10.74 The Committee note with concern that although foreign institutional finance which started in 1992 and emerged after the mid-90s as the single largest source of funds flowing into the stock market, and thus singly contributed to the exponential increase in daily stock market turnover, neither the Regulators nor the Ministry of Finance took steps to carefully monitor and effectively regulate the flow of foreign funds into the market. Nor was this done with regard to domestic fund flows into the market.

## RECOMMENDATIONS

10.75 Though the Committee appreciate the steps taken by RBI from time to time, they are of the considered view that unless the regulator is ever-vigilant, rules/regulations/guidelines cannot by themselves end aberrations in financial system. As with liberty, eternal vigilance should be the watchword of the regulator. Most importantly, the legal framework must be such as to provide for strict laws which are enforced expeditiously so that a sense of fear is created in the minds of wrong-doers. Sadly, existing laws do not inculcate such a deterrent sense of fear among perpetrators of crime.

10.76 Governor, RBI conceded that at present our system is "non-functional". Yet, RBI has been rather tardy in suggesting amendments to the existing legislative provisions to make them stronger and more punitive. For instance, amendments to the Public Debt Act, 1944 in response to the 1992 recommendations of the previous JPC have been under process for seven years since 1994 and are yet to be effected. Similarly, it was not till after the present scam involving UCBs came to light that amendments were proposed to the Banking Regulation Act, 1949 to bring some of the provisions regarding cooperative banks at par with those of commercial banks. Moreover, the enhancement of the penal provisions of the Banking Regulation Act, 1949 are yet to be mooted by the RBI. Legislative amendments based on the recommendations of the Dr. L.N. Mitra Committee (2001) have also not seen the light of day so far. The Committee deplore the half hearted and casual manner in which these critical matters have been dealt with and desire that proposals already forwarded by the RBI to the Ministry of Finance be cleared expeditiously. Particularly in the present environment, when financial markets are getting integrated, it is essential that a thorough review be made of all existing laws relating to the regulatory responsibilities of RBI.

10.77 The Committee find that the system of annual financial inspection has been overhauled and a system of on-site as well as off-site monitoring exists as a part of the new supervisory strategy. At present, all commercial banks are inspected at an interval of one year and in the case of Co-operative banks also the periodicity of inspections has been reduced from two years to one year. However, failure of the scale of MMCB poses a serious question on the efficacy of the supervision which is currently in place particularly in the urban co-operative banking sector. Moreover, scrutiny of inspection reports of various banks shows that while at the higher echelons of RBI, there is a paradigm shift of attention to qualitative factors, ground-level inspecting officials are still transaction based in their approach. What is required is not a proforma approach to inspections, but an approach designed to flag errors and deficiencies so as to enable qualitative appraisal to be effected at the level of each bank. Given the complexities of changes in the banking industry, the Committee feel that without a mindset change in the field level, the inspection reports would continue to be inadequate. The utility of off-site inspection reports will also not throw up significant indicators, if the whole process remains mechanical. The Committee, are therefore, of the view that there is imperative need to further improve both on the on-site as well as off-site supervision so that these become more bank-specific. RBI must also identify best practices found across banks and establish uniform standards to be followed by all banks.

10.78 The Committee were also informed by the RBI that it normally takes two to three months time to conduct inspections after which the inspection reports are discussed with the top functionaries of the banks as well as in the Board of Financial Supervision. Thereafter, according to RBI, action points are vigorously followed up for compliance. However, it has been noticed by the Committee that often the same type of mistakes/shortcomings get repeated year after year. This reflects adversely on the prevailing system. The Committee, therefore, feel that there is need to evolve an effective mechanism under which it must be ensured that discrepancies once pointed out are removed forthwith by the banks concerned. In case of non-compliance, individual accountability must be fixed on those who are responsible. The Committee further suggest that comments made by RBI should be published in the Annual Reports of the banks along with the financial results, to ensure greater transparency so that shareholders get a better idea about the operations of the bank. This might also induce the banks to be more compliant. There is a feeling in RBI that sudden firm and timely action against the management of the banks may lead to a run on the banks. However, the Committee are of the view that firm and timely action might forestall the possible surfacing of major failures and in some cases run on the banks.

10.79 The Committee also take note that on many occasions guidelines/instructions issued by RBI which have an important bearing on the operations of the banks, are not followed scrupulously by individual banks but in most cases RBI condones such transgressions. For instance, though there is an RBI circular of 25.7.1994, Audit Committees were not constituted by the MNCB and City Co-operative Bank. In the case of MNCB, there were violations of credit exposure to single as well as group borrowers, including the group belonging to the Chairman, in violation of RBI directives on credit exposure, yet corrective actions were not effectively pursued by RBI. At the same time it has also been found that some of the guidelines issued by RBI lack clarity. This was what happened in the case of instructions issued for financing of IPOs and arbitrage. It is, therefore, essential that not only should the guidelines be unambiguous but the banks also should be mandated to follow these guidelines. The Audit Committee of the Boards should also look into the implementation of the guidelines. In case of non-compliance with the instructions, individual accountability needs to be fixed, otherwise the very purpose of issuing guidelines gets defeated.

10.80 Audit is the backbone of the banking system. Whereas auditors of commercial banks are appointed by RBI, for cooperative banks, the auditors are appointed by the Registrar of Cooperative Societies. It has, however, been noticed that the auditors in the case of the Madhavpura Mercantile Co-operative Bank and the City Co-operative Bank have failed to discharge their responsibilities diligently resulting in a situation where there was a run on the banks and the depositors were duped. In most cases these auditors are not qualified chartered accountants, and so they fall outside the ambit of the Institute of the Chartered Accountants and no disciplinary action can be taken against them. Therefore, the RBI has now proposed to amend section 30 of the Banking Regulation Act, 1949 so that in future they are authorized to appoint the chartered accountants even in the case of the Co-operative banks. The Committee are, however, shocked to find that the Institute had failed to impose punishment even against a single auditor of the 17 auditors whose names had figured in the Janakiraman Committee, during the investigations of 1992 scam. It is all the more disconcerting to find that so far no concrete action has been taken to amend the Institute of Chartered Accountants of India Act, 1949 with a view to making it an effective instrument of deterrence and punishment, although a proposal in this regard is reported to have been forwarded by the Institute to the Government way back in 1994. The Committee take a serious view of such an apathetic attitude. They therefore recommend that an independent Board should be constituted under a separate statute, which should be responsible for ensuring quality in audits and also be empowered to take speedy disciplinary action against the defaulting auditors. The members of the Board should also

comment on the manner in which transactions are handled, adherence to prescribed systems and procedures and whether all the risk is getting recorded and reported to the Board. Besides, RBI in their inspection reports, needs to comment on the quality of the audit carried out by the auditors and comment on the handling of the issues by the Board of Directors. In order to create a sense of responsibility amongst auditors and also to deter those who either casually/negligently or in connivance with the management hide vital information, the penal provisions in the statute should be strengthened.

10.81 The Committee are given to understand that so far as the existing mechanism of vigilance in the public sector banks is concerned, the Chief Vigilance Officers are appointed from other banks/RBI etc. The Chief Vigilance Officer functions independently and reports directly to the Chief Executive of the bank under the overall control of the CVC. There is also a system of preparing a list of officials of doubtful integrity and keeping surveillance on them with a view to preventing frauds. In the case of private sector banks, including foreign banks, there is a system of vigilance which is generally with the Audit and Inspection Department. The Committee are of the considered view that any system in which the head of the vigilance cell is made to work under the control of the Chief Executive can hardly deliver the goods, more particularly when, apparently, quite a few of the irregularities committed are not only in the notice of the Chief Executive but are done at his instance. The 1992 JPC report had also underlined the importance of vigilance and strongly recommended the need to strengthen the vigilance machinery in the banks. The RBI in their action taken reply had mentioned that the Government had accepted the recommendations of the Ghosh Committee (1991) and accordingly instructions had been issued to the banks. Vigilance cover of the Chief Vigilance Officers had been extended over the subsidiaries also. The Committee are of the view that these measures alone are not sufficient and in order to enable the Chief Vigilance Officers to discharge their functions effectively and independently, it is also necessary that they be made accountable not to the Chief Executives but to the Committee on Audit of the Banks and through this Audit Committee to the entire Board of Directors.

10.82 With the gradual liberalization of the Indian financial system and the growing integration of domestic markets with external markets, the risks associated with banks' operations have become complex and large, requiring strategic management. Events that affect one area of risk can have ramifications for a range of other areas. The Committee were given to understand that RBI issued comprehensive guidelines on 'Risk Management Systems in Banks' in October, 1999 which, coupled with guidelines on Asset-Liability Management Systems, issued in February, 1999, were intended to serve as a benchmark to the banks. Since the irregularities can be minimized if proper risk management are in place, the Committee are of the view that banks, therefore, must attach considerable importance to improving their ability to identify, measure, monitor and control all level of the various types of risks undertaken. Risks attached with assets and liabilities need to be suitably commented upon in inspection reports. The Committee regret that although the risk based approach to supervision, which is said to be an improvement over the current CAMELS approach was announced in the Monetary and Credit Policy (April 2000) two and a half years later, it still remains to be implemented. The Committee therefore recommend that RBI must ensure that same is implemented expeditiously so that the commercial banks have comprehensive risk management systems in place, including the risk-based audit system. RBI must also ensure uniform accounting practices and risk management systems in the banks. At the same time, with a view to ensuring that liquidity in the market does not get eroded, RBI must ensure that its latest guidelines issued on 11 May, 2001 are implemented. *Inter-alia*, these guidelines have asked banks to ensure that that their exposure to stockbrokers is well diversified and that the track record of stockbrokers is taken into account before sanctioning advances.

10.83 Both high quality of supervision and introduction of the Risk Management Systems require up-gradation of technology in the banking system. As a part of the restructuring of the banking system, special emphasis is required to be given to effecting improvements in payment and settlement systems. There is a dire need to create a strong national payment system, faster computerization of branches and strengthening of the accounting system. Prominent among the measures which have also been recommended by the Committee on Technology Upgradation (1999) include introduction of Electronic Funds Transfer (EFT), Real Time Gross Settlement System (RTGS), Centralised Funds Management System (CSMS), the NDS and the Structured Financial Messaging Solution (SFMS), which will provide the backbone for all message based communication over the Indian Financial Network(INFINET). Pace of progress in these areas requires to be speeded up. The Committee feel that RBI has a long way to go in this area and desire that all efforts be made in this regard with a view to ensuring that technology gets upgraded within a stipulated time frame. This aspect needs close monitoring.

10.84 The Committee in the course of their examination came across a number of cases where funds taken from the banks/Financial Institutions were not used for the purposes for which the funds were lent and had been diverted to the share market. The amount of funds which were sanctioned to different groups of companies and the details thereof have already been mentioned in detail elsewhere in the report. The Committee find that the activity of diversion of funds is not culpable either under the Banking Regulation Act or under the Indian Penal Code. The Governor RBI candidly admitted that the system as it exists today is not effective in preventing diversion of funds. The Committee were further informed that in pursuance of the recommendations of the Standing Committee on Finance, a Working Group under the Chairmanship of the IBA Chairman, Shri Kohli was constituted to look into this issue. The Group submitted its Report in November, 2001. It considered the issue and made a number of recommendations which included the definition of 'wilful default'. It also recommended punitive action for such wilful defaulters. It has also been recommended that the defaulters be debarred from institutional finance from Public Sector Commercial banks, DFIs, Government owned NBFCs, investment institutions etc. initially for a period of five years. Amongst other recommendations, the Group has also suggested that statutory amendments be initiated to empower banks and FIs to attach the assets charged to them as security directly without the intervention of the Courts of Law. With regard to filing of criminal cases against the defaulters, the Group opined that since the prime concern of the lenders was recovery of dues and filing of criminal cases against the defaulters would not necessarily lead to such recovery, for which a separate 'money suit' would also need to be filed simultaneously, causing thereby an unavoidable burden on the lending institutions, the criminal proceedings against the wilful defaulters should be initiated selectively. The Committee find that based on the recommendations of the Group RBI has already issued a circular on 30.5.2002 and the Government has also introduced a bill on 'The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest' under which the Banks and FIs have now been authorized to attach the assets charged to them without the intervention of the Court or Tribunal. The Committee are, however, constrained to note that even this circular is silent with respect to fixing criminal liability against those who siphon of funds deliberately, resort to mis-representation, falsification of accounts and indulge in fraudulent transactions. In view of the fact that as regards judicial interpretation of Sections 405 and 415 no offence of breach of trust or cheating is construed to have been committed in the case of loans, it is essential that such offences are clearly defined under the existing statutes governing the banks, providing for criminal action in all such cases where the borrowers divert the funds with malafide intention. Though the Committee agree that such penal provisions should be used sparingly and after due diligence and caution, at the same time it is also essential that banks closely monitor the end use of the funds and obtain certificates from the borrowers certifying that the funds have been used for the purpose for which these were obtained. Wrong certification, should attract criminal action against the borrower.

10.85 Another related problem is the issue of 'financial frauds'. During the year 2000-01, RBI in its report on Trend and Progress of Banking in India (2000-01) reported 50 cases of large value frauds (Rs 1 crore and above) involving Rs. 506.34 crore. The major factors facilitating the perpetration of frauds include non-observance of laid-down systems and procedures by bank functionaries, nexus or collusion of bank staff with the borrowers/depositors, negligence on the part of the dealing officials/branch managers, failure of internal control systems, inadequate appraisal of credit proposals and ineffective supervision. During the course of the present examination, similar irregularities were noticed in the case of private as well as co-operative banks. Moreover, there is no separate Act under which scamsters can be booked and even in cases where criminal proceedings are launched cases drag on for years together in Courts, with the result that the perpetrators of frauds are seldom punished. The Committee were informed that in 1991, the Ghosh Committee was set up to enquire into various aspects relating to frauds and malpractices in banks. The Committee had made about 125 recommendations, most of which were accepted by RBI and implemented. However, with a view to examining certain legal aspects including attempting a definition of Financial Fraud and laying down procedural guidelines to deal with financial frauds, recently another Committee under the Chairmanship of Dr. L.N. Mitra was set up. The recommendations of the Mitra Committee are in two parts— Part I deals with recommendations which can be implemented without any legislative changes and are preventive in nature and Part II requires legislative changes for implementation. Some of the important recommendations contained in Part II include a separate Act to deal with financial fraud, making financial fraud a criminal offence, placing special responsibility on the regulator, setting of a separate institution for investigation, special courts for trying cross-border financial frauds as well as all offences under the proposed Financial Fraud Act. Though as reported by the RBI, all the recommendations under Part I have been accepted and instructions issued on 3/5/2002, the recommendations under Part II are yet to be implemented. The Committee desire that since these recommendations have an important bearing on the sound functioning of our financial system, the same should be implemented expeditiously. The Committee express regret at the tardy manner in which the issue of financial fraud has been addressed by the RBI although the Ghosh Committee (1991) and the L.N. Mitra Committee (2001) have highlighted this issue. Despite the recommendations of the L.N. Mitra Committee in September 2001, no effective mechanism has been put in place including the enactment of proposed Financial Fraud Act to deal with this problem.

10.86 At present, the regulatory/supervisory framework for the Urban Co-operative Banks is the responsibility of RBI, State Governments and the Central Government (in the case of banks having multi-State presence). This results in overlapping jurisdictions and also at times in cross directives, which adversely hamper the functioning of these co-operative banks. Besides, it has also been noticed that State Registrars do not always act expeditiously on directions received from RBI, with the result that the managements of these banks are enabled to take advantage of existing loop holes to commit irregularities leading eventually to pecuniary loss to the small depositors. In the past, this issue has been considered by a number of committees, of which the Jagdish Capoor Committee and the Madhav Rao Committee are recent examples. These committees have also recommended that there is need to clearly demarcate the banking-related functions and other functions of cooperatives with a view to entrusting the regulatory responsibility separately to RBI and the Registrar of Co-operative Societies. The Madhav Rao Committee had also recommended that the only effective way of addressing the problem of dual control is to carry out amendments to the State Co-operative Societies Acts, the Multi-State Co-operative Societies Act, 1984 and the Banking Regulation Act, 1949. They have suggested different sections under the B.R.Act, 1949 which are required to be amended, including amendments to section 30 and 36AC under which RBI will have the power to appoint chartered accountants to audit the accounts and also be authorised to remove managerial and other

persons from office or appoint additional directors. The Committee were informed that the issue relating to the amendments to the State Co-operative Societies Acts was recommended by RBI to the Government of India in the year 2000 with the request that the matter be taken up with the State Governments. However, the Ministry in 2001 advised RBI that it may be possible to bring co-operative banks under the discipline of RBI by making suitable amendments to the B.R. Act, 1949. Accordingly, RBI in May 2001 submitted proposed amendments to the Ministry of Finance but these proposals are still pending consideration. In the meantime, the RBI has mooted another proposal of setting up a separate apex body for regulating and supervising the co-operative banks, stressing that since a large number of co-operative banks are widely dispersed all over, RBI is not well-equipped to supervise them. According to RBI, this apex body should have representatives of the State Government, Central Government, RBI and other professionals. It should be an independent expert body to be able to discharge its supervisory role more effectively. The Committee appreciate the problems which emanate from duality/multiplicity of control in the case of the Urban Co-operative Banks but caution that the Government while considering the proposal of a separate apex body, should give due consideration to the problem of coordination and ensure that there is no dilution of responsibility. The proposed amendments to the relevant Acts should be carried out expeditiously so that an effective regulatory/supervisory mechanism is established without further delay.

10.87 The Committee find that bank mergers is a recent phenomenon in our country and before the merger, sanction of the Reserve Bank of India is required as stipulated under section 44A of the Banking Regulation Act, 1949 and the role of the RBI is limited. No merger is allowed unless the scheme of amalgamation draft has been placed before the shareholders of the banking company and approved by a resolution passed by the majority representing two-third value of the shareholders. As such RBI does not have any role to play regarding the swap ratio arrived at and in case of any dissenting shareholder, the RBI has to determine the value of the share price which is final. This practice is at variance from that of the merger in the case of the companies, where as per the Companies Act, the approval of the court is required before the amalgamation/merger between the two companies, which also ensures fair price. The Committee therefore, recommend that RBI should discharge proactive role in laying down the guidelines to process a merger proposal in terms of the abilities of investment bankers, the key parameters that form a basis for determining swap ratios, disclosures, the stages at which Boards will get involved in order to have meaningful Board level deliberations, norms for promoter buying or selling shares directly/indirectly, during, before/after discussion period etc. Without this, many mergers will become a subject of public debate, which may not all the time necessarily be constructive.

10.88 The Committee during the course of their entire examination in the present scam have found that there is no agency in our country which monitors the inflow as well as outflow of the funds, with the result that no body is in a position to say with any certainty as to how much legal or illegal money has entered the financial system and what are the various sources. In the case of OCBs for instance, there is no regulatory agency which monitors the large volume transactions. RBI also did not even inspect all the banks having large number of OCB accounts. Though the Committee were informed by the RBI, that under the RBI Act, 1934 this kind of mandate has not been bestowed upon it, they are, however, of the considered view that the RBI being the sole authority which lays down monetary policy for the country, is the only appropriate agency which can be entrusted with discharging this job. They therefore, desire that Government may seriously examine this issue.

10.89 With the banking sector being the mainstay of financial intermediation in emerging economies, developing a sound and healthy banking system through promotion of prudent financial practices is viewed as a *sine-qua-non* for safeguarding financial stability. In order to achieve high standards of performance, it is, therefore, imperative that the banks follow strategies and techniques which are basic to the tenets of sound corporate governance. These include capable and experienced Directors in the Board, efficient management, coherent strategy and business plan and clear lines of responsibility and accountability. While the primary responsibility for good corporate governance in the case of the banks rests with the Board of Directors, the role played by the Government, regulator, auditors and different banking associations are equally important. The Committee find that recently an Advisory Group set up under Shri M.S. Verma in its report submitted in May 2001 has made important recommendations with regard to sound corporate governance and has underlined the need to ensure that the Directors on the Boards are conversant with complex issues such as risk management, need for enhanced transparency and disclosures in respect of various aspects of boards' constitution and functioning, strengthening the Management Information System, strengthening internal control mechanisms, cross border supervision, etc. The Committee while endorsing these recommendations desire that the same be implemented expeditiously.

## CHAPTER XI

### DEPARTMENT OF COMPANY AFFAIRS

11.1 The role of Department of Company Affairs (DCA) insofar as Capital Markets is concerned is perceived to be limited to the provisions of the Companies Act, 1956 which are within its purview and not transferred to the SEBI.

#### 1. Violations by Companies

11.2 Section 209A of the Companies Act, 1956, empowers the Registrars of Companies to undertake inspection of the books of accounts and other records of companies. Over a period of time between June and December 2001, the Department of Company Affairs ordered inspection of 98 companies as were being named in SEBI's "Preliminary investigation." The Department has so far received 84 inspection reports. Examination of these reports has, in turn, led to 24 further inspections being ordered. In respect of the 84 inspection reports received, the Department has so far ordered/launched 539 prosecutions. Out of these, 58 prosecutions have been launched/ordered for major offences as shown below:—

Sl. No.	Section	Offence	Penalty provided	No. of prosecutions ordered/ launched
1	2	3	4	5
1.	58A	Acceptance of deposits in excess of prescribed limits and contrary to rules.	Fine not less than the amount of deposits.	07
2.	62/63	Issuing a prospectus which includes any untrue statement	Imprisonment upto two years or fine upto Rs. 50,000 or both.	01
3.	68	Fraudulently inducing persons to invest money	Imprisonment upto 5 years or fine upto Rs. 1,00,000 or both	01
4.	77	Restriction on purchase by company, or loans by company for purchase, of its own or its holding company's shares	Fine upto Rs. 10,000	01
5.	209A	Failure to produce books and papers, furnish information or explanation, etc. relating to inspection	Fine not less than Rs. 50,000 and also imprisonment upto one year.	03

1	2	3	4	5
6.	295	Loans to directors etc. without approval of Central Government	Fine upto Rs. 50,000 or imprisonment upto six months.*	22
7.	370	Loans to other body corporates	—do—	03
8.	372	Investments in other body corporates	—do—	08
9.	372A	Inter-corporate loans and investments	Fine upto Rs. 50,000 or imprisonment upto two years.*	10
10.	628/211	False statement made in any return, balance sheet, prospectus, etc.	Imprisonment upto two years and also fine.	02
Total				58

\* Were any such loan etc. has been repaid in full, no punishment by way of imprisonment shall be imposed and where the loan has been paid in part, the maximum punishment by way of imprisonment shall be proportionately reduced.

11.3 It may be observed from above that 45 out of 58 prosecutions relate to diversion of funds under various Sections viz. 62/63, 77, 295, 370, 372 and 372A. The above 58 prosecutions are against thirty companies including Cyberspace Ltd. for violations u/s 62/63 and 209A, DSQ Software Ltd. u/s 372A and 295, Adani Exports Ltd. u/s 295 and 372A, Amara Raja Batteries u/s 295, Pentamedia Graphic Ltd. u/s 628/211, Silverline Industries Ltd. u/s 370 and SSI Ltd. u/s 58A.

11.4 SEBI's investigation reports in regard to the Stock Market Scam had revealed that entities associated with Ketan Parekh had received huge amounts from various corporate groups during January 2000 to April 2001 as shown below:—

(Rs. in crore)			
Name of Group	Amount received	Amount returned	Net Balance
Adani Group	340.65	208.20	132.45
Cadila Group	33.97	5.00	28.97
DSQ Group	85.67	10.00	75.67
Essel Group	706.40	251.55	454.85
HFCL Group	908.99	354.97	554.02
Kopran Group	77.94	50.00	27.94
Nirma Group	65.10	65.10	0.00
Total	2218.72	944.82	1273.90

11.5 Ketan Parekh entities also reportedly received around Rs. 80 crore from subsidiary of Ranbaxy group. Apart from these, Ketan Parekh entities are stated to have an outstanding dues of about Rs. 267 crore to Global Trust Bank and Rs. 37 crore to Shonkh Technologies.

11.6 DCA has indicated that out of the ten companies cited above, Adani Exports Ltd., DSQ Software Ltd. and Siti Cable Ltd., a company of Essel Group have violated the provisions relating to transfer of funds. Inspection report of Cadila Healthcare is stated to be not yet ready. DCA has pointed out that the remaining six companies have not violated the provisions relating to transfer of funds.

11.7 According to DCA, removal of restriction on Section 372-A, that is, inter-corporate deposits two years back by way of liberalizing amendments has been the major reason for huge transfers of money from companies to Ketan Parekh.

11.8 DCA inspections have revealed that in several cases the largest, often listed, company in a group has transferred its money to other group companies, normally private or at least unlisted, and these smaller group companies have then transferred the funds to the Ketan Parekh group of companies; further, once the money reached any company of the Ketan Parekh group, it was often rotated amongst the various companies of this group. Apart from taking action where offences under the Companies Act have been revealed, the DCA is considering what improvements in the law can be made to check such violations. The following suggestions are stated to be under consideration:—

- (a) putting a cap on the number of investment companies that can be set up by an individual;
- (b) to prohibit a person from being a significant shareholder or director in more than the prescribed number of investment companies; and
- (c) to prescribe a minimum qualifying shareholding for a person to be a director in a company which deals in shares and securities.

11.9 DCA inspections have also revealed that small private companies with very little paid up capital have been used to transfer huge amounts of money. The DCA is, therefore, examining the feasibility of (a) prescribing a limit on lending to/borrowing by such companies, as a multiple of the paid-up capital; and (b) prescribing a limit on turn-over also as a multiple of paid-up capital.

11.10 To a query whether inspections undertaken by DCA have covered the year 2000-01, DCA stated that in several inspections (approximately 28) the audited accounts for the financial year 2000-01 were not available at the time of inspections. In fact, most inspection reports do comment on SEBI's remarks about the company. Since SEBI's observations about the company pertains to year 2000-01, this would seem to indicate that the inspecting officers have/had access to the relevant papers/accounts of this financial year. The DCA feels that even if these companies were to be revisited, on the basis of audited accounts for the year 2000-01, it will not make a significant difference to the quality on findings of the inspection reports.

## **2. Regulatory effectiveness**

11.11 Regional Directors (RDs) and Registrar of Companies (ROCs) are nominated by SEBI on the Governing Board of Stock Exchanges. Pointing out this fact, the Committee asked whether RDs and ROCs take any action if there is any unreasonable speculation in the market. In response the Secretary, DCA said that, "each time there is a movement in the stock market if

you rush to a company and invade it, that kind of tendency is not the right kind of stance to adopt. It should be based on some solid information". The Committee emphasized that when the price of a company's scrip increases abnormally, it should ring alarm bells that something was going wrong with the company and DCA should initiate inspection. In response, the Secretary DCA said: "we are contemplating on your observation that when we are there in the stock market, why do we not take action. There is a lot of truth in what you are saying. We will keep that in mind."

11.12 The punishments prescribed in the Companies Act for some serious offences are insignificant. Enquired about the maximum and minimum penalties provided in the Act, a representative of DCA stated that under Section 77 the minimum penalty could be rupee one and under Section 68 a maximum penalty of five years imprisonment and a fine of one lakh rupees. When the Committee pointed that certain penalty provisions appear to be totally inadequate, the DCA agreed with the view and stated in a written reply that in respect of certain offences, such as offences under Section 77 of the Companies Act, the penalties prescribed are inadequate and that the penalties should not only be increased but should be related to the gravity of the offence. The DCA is, therefore, stated to be considering the desirability of (a) making some of the offences non-compoundable and (b) prescribing monetary penalties which are a percentage, or multiple, of the money involved in the offence/scam. The Department has set up a Committee under the chairmanship of an eminent company lawyer, Shri Shardul Shroff to examine the question of rationalising penalties.

11.13 Pointing out the inadequacy of powers of DCA, the Secretary, DCA stated during evidence: "Now, we, in the Department, have no powers. We do not have the powers to remove the management. We have to file a case in the Company Law Board. We do not have the power even to undertake investigation. For that, we have to seek an approval from the Magistrate. In every case of investigation which is done, almost every case, they go to the High Court and get it stayed".

11.14 The Committee felt that the Department should have more teeth to function as an effective regulator with the view to controlling such undesirable activities of companies as may adversely affect public interest and small investors.

11.15 According to DCA many of the provisions in the Companies Act which was originally a product of the "control and permission" regime have been liberalized over the years. However, a liberalised regime should have been accompanied with effective regulatory provisions, but these are clearly missing in the Companies Act. The penalties are nominal, the offences are easily compoundable, and even investigations or special audits (which are merely fact-finding steps) can be undertaken only after lengthy procedures, which render these measures ineffective for any speedy action; besides very often these are stalled by the companies by resorting to Court action. Thus, for effective regulation, certain improvements in the Companies Act are urgently called for.

11.16 In order to enable the Department to take speedy and effective action on violations, DCA has proposed the following amendments in the Companies Act, 1956 :—

S.No.	Section	Suggested Amendment
1	2	3
1.	77	Maximum penalty is Rs. 10,000. Suggested that penalty be a percentage of the amount involved. The percentage can be prescribed as a minimum of 10% and a maximum of 50% of the amount involved, leaving the exact percentage to the adjudicating authority.

1	2	3
2.	372A	Prescribed penalty is fine or imprisonment, making it compoundable. Suggested that offence be punishable by fine and imprisonment, thus making the offence non-compoundable.
3.	372A	Loans to partnership/proprietorship firms in which directors are not interested should also be covered.
4.	372A	Loans to subsidiary should also be covered. No exemptions for them.
5.	274(1)(g)	Directors who commit offences under 77, 372A and other similarly serious sections should be covered.
6.	227(4A)	Greater responsibility on auditors to report violations of sections 77, 372A, etc.
7.	*	Onus to prove that loans/advances given by companies not used to rig their share prices should be on the company.
8.	*	Evidence through commissions should be possible to ensure speedier disposal of cases.
9.	*	Department/NCLT should have certain pre-emptory powers such as seize and desist, attachment of bank accounts, etc.
10.	*	Loans to companies should be limited to a proportion of the borrowing company's net worth.
11.	*	DCA to have powers to intervene and prosecute in case company or directors or managers are indulging in insider trading.
12.	*	Powers to DCA to lift the corporate veil in so far as persons behind the company are concerned, as a condition of registration, or continuation of registration.
13.	*	Opening of a "Serious Frauds Office" in DCA to investigate corporate misdemeanor.
14.	*	Prescribing minimum penalties and compounding fees and rationalization of penalties.
15.	*	Limit the deposits/loans that a receiving company can take, as a multiple/percentage of the paid-up capital.
16.	209A	Outsourcing of inspections, supporting specialized Inspection agencies.
17.	*	Control, in the interim, expenditure on legal fees, consultancy, travel, transportation, entertainment, daily allowance etc. if change in management/appointment of special directors is under consideration. Shareholder money should not be misused to get legal/accountancy advise by manager on how to use loopholes in law to cover his/her misdeeds.
18.	235 to 241	Power of investigation to be with DCA, not a quasi-judicial authority like CLB.

1	2	3
19.	621A	Compounding of offences to be with DCA, not a quasi-judicial body like CLB.
20.	233A	Circumstances for ordering special audits and powers of Special auditors to be amended.
21.	408	Power of appointment of the directors to be with DCA, and not with quasi-judicial authority like CLB.

\* Section yet to be determined.

### 3. Slow Disciplinary Procedure

11.17 Commenting on the delay on the part of the Institute of Chartered Accountants of India (ICAI) in taking action against the auditors indicted by the previous JPC, a representative of DCA has stated that basically the disciplinary procedure of the ICAI as put down in the Act is excruciatingly slow. It involves four opportunities to be given to the person being inquired into. Listing out the four opportunities, the Secretary, DCA said that there is one opportunity at the Preliminary level, one opportunity at the Council level, one at the Disciplinary Committee level and finally one at the High Court level. A representative of DCA said in this regard that they were extremely unhappy with the lengthy procedure involved in taking disciplinary action against auditors for professional misconduct.

11.18 Elaborating the position in this regard, the Secretary DCA said : "We are concerned about the lengthy procedure which is prescribed for disciplinary action against Chartered Accountants. That is one thing. We have also expressed concern about the fact that this is basically a body of Chartered Accountants taking action against Chartered Accountants. We feel that this kind of an arrangement has some in-built limitations, that it may not be possible for Chartered Accountants or any body of persons to take action against themselves. Thirdly, the whole Institute of Chartered Accountants is an elected body plus six representatives from the Government. We feel that the very fact of elections in that professional body also brings in certain limitations in enabling the members to take action against certain members". The witness felt that in a disciplinary procedure relating to Chartered Accountants, there must be an outside presence. He cited in this connection that even in the USA, they have realized that the regulatory Committee relating to Chartered Accountants must have a majority of non-Chartered Accountants.

11.19 The affairs of the Institute of Chartered Accountants of India (ICAI) , are managed by its council and the Council is composed of not more than 24 persons elected by the Members of the Institute and six persons nominated by the Central Govt.

11.20 It transpired during the oral evidence of the representatives of ICAI that the Institute had suggested in 1982 amending of provisions relating to disciplinary matters. The suggestions included conditional renewal of certificate of practice, increasing the strength of council members from 30 to 40, increasing the composition of examination committee with provision for co-option from outside the membership and enlarging the composition of Disciplinary Committee. The president ICAI stated during evidence that from 1982 to 1994, the Government had taken no action in regard to these proposals. He claimed that the Institute had continuously followed it up with the Government. He further stated that in 1994, the Institute again submitted these proposals to the Government suo motu. Following a reference from the Government the Institute forwarded fresh proposals along with earlier suggestions. Thereafter, there was no response from

the Government though the Institute is stated to have been continuously following it up. It was only in 2001, that the Institute received a letter from the Government asking them whether they would like to take a fresh look at the suggestions that they had sent earlier. Subsequently, the Institute submitted some more suggestions.

11.21 During the oral evidence of the DCA, the Committee asked about the reasons for keeping the ICAI proposals for amendment of the provisions relating to disciplinary matter pending since 1984 particularly when DCA is unhappy about these provisions. A representative of DCA replied that ICAI had sent the proposal in 1994 and not in 1984.

11.22 As regards the present scam, the DCA has reportedly referred to the ICAI eight cases where there was some shortfall or some error on the part of Chartered Accountants. To a query by the Committee, the Secretary, DCA said that "under the Act we do have the powers even to prosecute Chartered Accountants, but it has been a provision which has been hardly used". When it was pointedly asked, as a regulatory authority of companies, what direct action was taken by DCA against the Chartered Accountants involved in the eight cases, the Secretary, DCA explained that, "we have got about 21 or 22 inspectors in the whole country.... It is our observation that while these inspectors try to do their best, they have got some in-built limitations. Looking into the finances, the balance sheets, the nuances of the accounts is a highly technical kind of job.... Instead of allowing a non-professional to proceed against professional Chartered Accountant and sometimes make mistakes, we thought it better to get it investigated by professionals. Sometimes, I also see mistakes. Although I am also a non-professional, I find in the inspection reports that our inspector has treated a thing in a non-professional kind of way."

11.23 Emphasising the need for improving the quality of inspection the Secretary, DCA stated during oral evidence that DCA "diverted a number of Registrars of Companies (ROCs) and others at the head office and in the field into inspection. Even then we have not been able to cope up with the quality of inspection. It leads to a lot to be desired. I think what qualitative change needs to be done is, for instance, we should have the authority to carry it out through a chartered accountant or some other professional.... Our inspectors are not trained, there is no fault on their part. We are thinking of putting them through aggressive training."

11.24 A report of the Working Group for amending the Chartered Accountants Act, 1949 forwarded by the ICAI on 3.7.2002 reportedly contained the following proposals specifically with regard to disciplinary actions against Chartered Accountants for professional misconduct :—

- (i) The composition of the Disciplinary Committee is proposed to be broad-based with 12 elected and 3 nominated members of the Council. The existing provision provides the DC to consist of the President, Vice-President and three other members of the Council elected by the Council (Section 17);
- (ii) The Disciplinary Committee is to function through a maximum of 3 Benches. This is proposed with a view to expediting proceedings (Section 21);
- (iii) A Screening Committee has been proposed for disciplinary matters/complaints. The Committee will consist of 16 members of the Council.
- (iv) Time frame proposed to be fixed for activities involved in the proceeding of Disciplinary Cases.
- (v) Council of ICAI to be vested with powers of awarding punishment in respect of all types of references, and appeals to lie to the High Court.
- (vi) Provision of Summary Proceeding in some cases.

11.25 DCA has stated that the proposals at (iii) (iv) & (vi) above have been suggested by ICAI for the first time. Broad-basing of the Disciplinary Committee as referred to at (i) above and constitution of Benches of Disciplinary Committee with flexibility based on "need-criterion" were also not there in the 1993 proposals.

11.26 A representative of DCA stated during evidence that the Department is hopeful of bringing an amendment in the Chartered Accountants Act before the Parliament by the Winter Session.

11.27 Asked about the steps needed for breaking the management-auditor nexus, the DCA stated in a written reply that the present scam has brought into focus the entire issue of the auditor-company relationship and of the non-audit services being provided by auditors. To examine this entire issue, from the point of view of ensuring the professional nature of the relationship, as also to examine the present system of regulation of the professions of Chartered Accountants, Company Secretaries and Cost Accountants, the Government have set up the Naresh Chandra Committee. Specifically, the Naresh Chandra Committee will examine:

- (a) the entire gamut of issues pertaining to the Auditor-Company relationship with a view to ensuring the professional nature of the relationship, in this respect to consider issues such as (but not limited to) rotation of auditors/auditing partners, restrictions on non-audit fee/work, procedures for appointment of auditors & determination of audit fees, etc.
- (b) measures required to ensure that the management and auditors actually present the true and fair statement of the affairs of the companies; in this respect to consider measures such as (but not limited to) personal certification by directors, random scrutiny of accounts, etc.
- (c) whether the present system of regulation of the profession of Chartered Accountants, Company Secretaries and Cost Accountants is sufficient and has served well the concerned stakeholders, especially the small investors, and whether there is advantage in setting up an independent regulator (along the lines of the recently passed Sarbanes-Oxley Act of 2002 in the USA) and, if so, what shape should the independent regulator take.

#### **4. Vanishing Companies**

11.28 The Capital market had witnessed a boom period during 1993-94 and 1994-95 when many new companies have tapped capital market and collected funds from the public through issue of shares/debentures and fixed deposits. Many of these companies have defaulted in their commitments made to the public while mobilizing funds. Some of these companies are not even traceable. This has caused disappointment and anxiety to the public who had invested their hard earned money in these companies. The Securities and Exchange Board of India (SEBI) has looked into this problem and has identified 229 listed companies which have collected funds through public issue and are not available now at their registered offices.

11.29 Pointing out that a number of companies which collected money from various people had run away, the Committee enquired what specific actions are taken by DCA to ensure that the depositor is paid his money fastest. In response, the Secretary, DCA said, "In case of companies which have sort of gone bust or not in good shape financially, whether they have run into genuine losses or manufactured losses, the unfortunate fact is that if these are shareholders, they have taken certain risk in investing in that. Now, the only way they can get any money, if at all they get back, is through the winding up process".

He further stated in this regard as follows:

“The arrangement is that if it is a company that has got assets and is not dying out, then the Company Law Board is the forum. If it is a company that is now sort of virtually *en route* to death, then it is through winding up proceedings.... If it is a Non-Banking Finance Company, then Reserve Bank of India sends the case to the Company Law Board. If it is a manufacturing company or any other company which is not a NBFC, then the Department (DCA) can send the case to the Company Law Board. The person who has lost his deposit in either of the case can directly go to the Company Law Board. That is the common legal forum, headed by a retired High Court Judge, for both NBFCs and Non-NBFCs”.

11.30 The present status of 229 vanishing companies as provided by DCA is as follows:—

Sl.No.	Status	No.
1.	Originally identified by SEBI	229
2.	Found to be regular in filing document	63
3.	Balance	166
4.	Companies started filing documents subsequently	65
5.	Companies under liquidation	28
6.	Seized by State Govt.	2
7.	Identified and asked to update document (default notice issued)	2
Still vanished		69

11.31 Prosecutions were launched against 135 companies for non filing of Balance sheet and Annual Report (out of these against 33 companies, police complaints were also filed). However, in December 2001, a decision was taken to proceed against these companies for non-compoundable offences, carrying the punishment of imprisonment. Consequently, 79 prosecutions under sections 62 / 63, 68 and 628 of the Companies Act have been launched as on 10.6.2002.

11.32 SEBI has debarred 87 companies and 336 directors u/s 11B of the SEBI Act from raising money from the Capital Market and dealing in Capital Market in any form, for a period of five years. The field offices of DCA have taken action against such companies for violation, if any, of the provisions of the Companies Act, 1956 and tried to enlist assistance of police authorities and general public to ascertain the whereabouts of such companies. A Central Coordination and Monitoring Committee consisting of Secretary DCA and Chairman SEBI was set up in March, 1999 for taking stringent action against unscrupulous promoters who raised moneys from investors and misused them. The Coordination Committee has met from time to time and has taken the following decisions:—

- (i) *the process of identifying vanishing companies has to be an on going exercise, a continuous vigil is to be maintained, and additions made to the list, as required.*
- (ii) *to continue action for filing prosecutions u/s 62/63/68 and 628 of the Companies Act, 1956 against the vanishing companies and their directors for Civil/Criminal liability for mis-statement in prospectus, fraudulently inducing persons to invest money and making false statements in the offer documents. Priority in action will be taken against the companies which had raised Rs.10 crore, or over.*

- (iii) In respect of the companies, which are still "vanished", it was decided that SEBI would engage a top lawyer and have a "model" FIR drafted by him/her and after approval of the Coordination Committee, this "model" FIR will be sent to all the Task Forces to register the FIR against all such companies.*
- (iv) Action against the companies that have gone into winding up or are before the BIFR and their directors will also be initiated after obtaining leave of BIFR/Courts, if such permission is required.*
- (v) SEBI would obtain advice from a top lawyer on the possibility of attachment of properties of the directors of vanishing companies.*
- (vi) The names of the directors of the vanishing companies shall be put in the website of DCA and SEBI if the directors stand disqualified as per section 274(1) (g) or if any company, and/or its directors are being prosecuted for non-compoundable offences.*

11.33 The Committee note that 45 out of 58 prosecutions for major offenses launched/ordered by the Department of Company Affairs (DCA) against companies involved in the present scam relate to diversion of funds. The major reason for huge transfers of money from companies to Shri Ketan Parekh is stated to be removal of restriction on inter-corporate deposits two years ago. In order to check violations in this regard, certain suggestions are under consideration by the DCA *viz.*, putting a cap on the number of investment companies that any individual can float, prohibiting a person from being a director in more than the prescribed number of investment companies, prescribing a limit on lending/borrowing by companies, etc. The Committee hope that DCA will arrive at expeditious decisions on these suggestions and bring forth suitable amendments in the Companies Act.

11.34 Section 408 of the Companies Act empowers the Central Government to appoint such number of persons on the board of a Company as directed by the Company Law Board (CLB) on a reference made by the Government to safeguard the interests of shareholders or the public interest. The Government having reason to believe that there has been mismanagement and/or oppression has decided to approach CLB to appoint Government directors in seven companies namely Padmini Technologies, DSQ Software Ltd., Kopran Ltd., Pentamedia Graphics Ltd., Panther Industrial Products Ltd., Panther Fincap and Management Services Ltd. The Committee feel that similar action should be taken on other companies which indulged in mis-management/oppression.

11.35 In regard to transfer of funds by six corporate groups to Ketan Parekh, DCA has informed that six out of ten corporate groups which transferred huge amounts to entities associated with Ketan Parekh, have not violated the provisions of the Companies Act. The Committee feel that more investigation is needed on this aspect.

11.36 The Committee feel that the Regional Directors and Registrar of Companies should benefit from their presence in the Governing Board of Stock Exchanges and initiate investigation when abnormal fluctuations in the price of a scrip is noticed.

11.37 The Committee note that penalties prescribed in the Companies Act are nominal and the offenses are easily compoundable. For instance, violation of restriction on purchase of its own shares by a company under Section 77 of the Act attracts a maximum fine of Rs.10,000 even if funds involved are in crores of rupees. The penalties, therefore, need to be rationalised and prescribed as a percentage or multiple of the money involved in the offence. The Committee hope that the Shardul Shroff Committee which has been set up to look into the question of rationalising the penalties will give its recommendations soon and early action will be taken thereon.

11.38 The regulatory powers within the Companies Act need to be strengthened to enable effective action on instances where corporate wrong doings come to light. At present, DCA has no powers even to undertake investigation. Such lacunae render the functioning of DCA ineffective and inhibit speedy action. Certain amendments listed out in para 11.16 have been proposed to enable the Department to take speedy and effective actions on violations. The proposals include vesting DCA with the power of investigation and compounding of offences, rationalisation of penalties and opening of a "Serious Fraud Office" to investigate corporate misdemeanor. The Committee urge that decision on these proposals be taken expeditiously and an amendment Bill be introduced in Parliament at the earliest. The Committee also feel that there should be a surveillance mechanism to enable suo motu action on erring companies.

11.39 The Committee are unhappy to note that no decision was taken by the DCA on the amendments on disciplinary matters proposed by the Institute of Chartered Accountants of India (ICAI) two decades ago except for seeking a fresh set of proposals from ICAI in 1994 and again in 2001. Given this background, the Committee are not convinced of the DCA explanation attributing the lengthy disciplinary procedure followed by ICAI as the reason for the delay in taking disciplinary action against auditing entities named by the previous JPC. The Committee note that a Working Group for amending the Chartered Accountants Act, 1949 has recently given its recommendations which include various suggestions on disciplinary matters, particularly, the question of fixing a time frame for proceedings in disciplinary cases. The Committee stress that as proposed by DCA, amendments to the Chartered Accountants Act should be brought before Parliament in the ensuing Session.

11.40 Admittedly, the quality of inspection by the DCA leaves much to be desired. It is a matter of serious concern that the DCA Inspectors are untrained and unable to cope with the quality of inspection. The Committee hope that the weaknesses in the system of inspection will be looked into with dispatch and appropriate remedial action taken without delay in order to have an effective inspection mechanism.

11.41 The Committee feel that the issue of auditor-management relationship needs to be addressed with a view to ensuring a healthy professional relationship between them. This could be achieved through rotation of auditors, restriction on non-audit fee, etc. The DCA has since appointed Naresh Chandra Committee to examine the entire gamut of issues pertaining to auditor-company relationship. The Committee urge that the Naresh Chandra Committee should complete its work within a time frame and enable expeditious action by the Government on its recommendations. The Committee feel that the desirability of having an arrangement in DCA for scrutiny of auditors' reports of all companies on regular basis needs to be examined with a view to taking suitable action on the qualifications made by auditors in their reports.

11.42 The Committee note that the action by SEBI and DCA has enabled the tracing of 160 out of 229 companies which were earlier treated as vanished. There are still 69 companies which remain untraced. The Committee urge that the 'model' FIR which is at drafting stage should be finalised soon and the Central Coordination and Monitoring Committee should ensure that FIR against all the vanishing companies are registered without further loss of time and further ensure that whereabouts of the vanishing companies are ascertained. The Committee also desire that definition of vanishing companies should be made comprehensive.

11.43 Apart from SEBI's action of debarring 87 companies and 336 Directors from accessing the capital market, the DCA has launched 79 prosecutions against these companies for non-compoundable offences carrying the punishment of imprisonment. What the Committee are seriously concerned is about how the investors may get their money back from the vanishing companies. The Committee urge that SEBI, DCA, Company Law Board and RBI should work

seriously towards achieving this objective and take all necessary steps, including attachment of properties of directors of vanishing companies.

11.44 The Committee feel that the role of companies to the extent that they impact on the Capital Market must be regulated within the Department of Company Affairs effectively and transparently. In this regard, a process of consultation must commence under the nodal Ministry.

## CHAPTER XII

### ACTION BY INVESTIGATIVE AGENCIES

12.1 The three investigative agencies namely the Central Bureau of Investigation (CBI), Central Board of Direct Taxes (CBDT) and Directorate of Enforcement took cognizance of the various kinds of offences committed by brokers, corporates, promoters etc. who were found to be involved in relation to the Stock Market Scam, 2001. The Committee sought from time to time the status reports of the investigations conducted by these agencies besides seeking information on specific points/issues. Investigation in CBI was conducted by its Economic Offences Wing, a separate division in the CBI for investigation of economic offences. CBDT's investigations relating to Stock Market Scam were focused on ascertaining the extent of undisclosed income generated as a result of the market activities of some of the brokers. The Committee also sought from CBDT information *vis-a-vis* the working of Double Taxation Avoidance Convention (DTAC) between India and Mauritius especially in view of the alleged misuse of the treaty which resulted in avoidance of capital gains tax by entities which invested in the Indian Stock Market *via* Mauritius route. The action taken by the Directorate of Enforcement related mainly to investigating violations committed by certain entities under FERA and FEMA and finding out the origin of funds credited in the accounts of a few FIs/Sub-accounts/OCBs which were operating in the Indian Stock Market.

#### 1. CENTRAL BUREAU OF INVESTIGATION

12.2 CBI derives its powers of investigation from Delhi Special Police Establishment Act (DSPE) and investigates cases notified U/S 3 of the DSPE Act, 1946. However, as the law and order is a State subject and basic jurisdiction to investigate crimes lies with the State Police, the CBI *suo moto* investigates cases against employees of Central Government/Public Sector Undertakings of the Government of India in the Union Territories. Investigation in respect of them is conducted in the States with the consent of concerned State U/S 6 of the DSPE Act.

12.3 As regards economic offences, CBI is empowered to investigate offences which are also notified U/S 3 of the DSPE Act in the Union Territories and such offences can be investigated in the State with the consent of the State Government as required U/S 6 of the DSPE Act. Therefore, in terms of Economic Offences, CBI can investigate:—

- (i) Cases of fraud, cheating, embezzlement and the like relating to companies in which large funds are involved and some other cases when committed by organized gangs or professionals having ramifications in several States.
- (ii) Cases having inter-state and international ramifications and involving several official agencies where it is considered necessary that a single investigating agency like CBI should be in charge of investigation.

#### Previous Scam Cases

##### Status of the cases

12.4 As regards different brokers charge-sheeted in pursuance of the investigations carried out by the CBI in 1992 Securities Scam, CBI has submitted that 23 brokers were prosecuted by

the CBI and that Shri Hiten P. Dalal had been convicted by the Special Court (Trial of Offences Relating to Transactions in Securities)(TORTS) Mumbai in two cases. Shri Harshad S. Mehta and Shri Abhay D. Narotam had been convicted in one case each by the Special Court.

12.5 The Committee were informed that out of 72 cases registered, charge-sheets have been filed in 47 cases, out of which the courts have disposed of 6 cases and the rest are pending trial. With regard to the slow rate of disposal, the witness stated:

".....It did not take 4 years for the 47 cases to be charge-sheeted. Most of the cases were registered in the year 1992 and the average time taken was three to four years. The long time taken is in the trial of the cases. Initially, the Government set up only one court to be headed by a judge of the rank of a Judge of the High Court. Now, though the court was exclusively set up for trying the security scam cases, it so happened that the Judge was also taking up cases, which he was earlier having in the High Court. So, he could not devote full time and attention to the trial of the security scam cases, which was expected. As a result of this, initially, the pace of trial, if I may say so, was excruciatingly slow.... We moved the Government to set up one more court. So, one more court was sanctioned but the time taken in positioning a judge was quite long.... but even then we found that two courts were also not enough. So, we moved for two more courts. Though two more courts have been set up, there are no judges and only two courts are really functioning where four courts should be functioning all at a time, attending to the trial of the cases on a day-to-day basis.... During the last six or seven years, we succeeded in getting the trial completed only of six cases. Out of these six cases, three cases have ended in convictions and three cases have ended in acquittal."

#### Missing Shares of Harshad Mehta and the role of the custodian

12.6 The custodian is appointed by the Government of India under the provisions of Special Court (TORTS), Act, 1992. The Custodian has been empowered U/S.3(2) of TORTS Act, 1992, to notify any persons/entity under the Act if he is satisfied that the said person/entity was involved in offences relating to transactions in securities after the 1st day of April 1991 or on or before 6.6.1992. All properties, moveable or immovable or both, belonging to notified persons/entities stand simultaneously attached by virtue of the provisions of Sec.3(3) of TORTS Act.1992.

12.7 On being asked about the reported missing shares of Shri Harshad Mehta, the witness deposed as under:—

"...A report was filed by the Custodian before the court that Harshad Mehta was supposed to deposit all his shares with the Custodian. On scrutiny, it was found that 27 lakh shares were missing."

12.8 The witness further elaborated as under:

".....that report was lodged before the Judge. The Judge examined the report of the Custodian and asked the CBI to investigate whether these were missing and, if so, how they were missing. On the directions of the Hon. Judge, CBI registered a case and it was found that 27 lakh shares were indeed missing. When we had evidence that they were missing, we arrested Harshad Mehta and his brother Ashwin Mehta. During their interrogation as well as the interrogation of some of their associates, it was established that 27 lakh shares they suppressed and did not hand over to the Custodian. It was in that connection that Harshad Mehta was arrested and kept on remand with the CBI where he was interrogated. Later on, after our interrogation was over, he was produced before the court and was sent to judicial custody where, unfortunately, he died. The

investigation of that case is almost complete and we shall soon be filing the charge-sheet in that case.”

12.9 Subsequently in a written reply CBI informed that in this regard a Misc. Application in the year 2000 was filed by the Custodian in the Special Court on 17.4.2000. The Court *vide* orders dated 30.04.2001 directed investigations by the CBI in the matter. Consequently case RC., 5(E)/2001-BS&FC/Mum. dated 22.05.2001 was registered.

12.10 On having asked whether these shares were stolen from the possession of the custodian, the witness replied:

“Our investigation has not established that those shares were stolen from the possession of the Custodian.”

12.11 Regarding Shri Harshad Mehta’s explanation about this during his interrogation by CBI, the witness stated as under :

“If I can share this in confidence, I would submit that he did admit that he had suppressed, concealed the shares. But at the same time, he said that it would be suicidal for him if he admitted that in the court.”

12.12 Subsequently CBI in a post evidence reply submitted that in the month of June/July 1999 S/Shri Ashwin S. Mehta, Harshad S. Mehta and Smt. Jyoti H. Mehta had written letters to the Custodian that 27 lakh shares purchased by their group companies were missing and that the same pertained to about 90 companies. The Custodian doubted diversion of the shares by the notified persons and their group companies as the details furnished about the missing shares was incomplete. This was besides the fact that the notified persons had not lodged a complaint with the police in this regard for 7 years. The Custodian in this connection filed miscellaneous petition in the Special Court, Mumbai. Consequently, a case was registered and taken up for investigation by CBI. It was further added that the shares in question were never missing/stolen from the custody of the Custodian. However, further investigation in this regard would be made with the office of Custodian.

### **Investigations in respect of Ketan Parekh Group, MNCB, Bank of India**

(a) Investigation in case No. 3-E/2001-CBI/BS & FC/Mumbai

12.13 In case No. 3-E/2001, the main allegations are that on 8th and 9th March, 2001, 13 pay orders issued by Madhavpura Mercantile Co-operative Bank Ltd, Mandvi Branch, totalling Rs.137 crores in favour of certain firms of accused Shri Ketan Parekh were purchased/ discounted by the Bank of India, Stock Exchange Branch, and subsequently when these pay orders were sent for clearance on 12/03/2001, the RBI returned them because MNCB, Mandvi Branch, did not participate in the clearing on that day. On the other hand, after getting immediate credit, the funds were transferred by the accused to various accounts of the companies which are being controlled by Shri Ketan Parekh and his family members. The case was charge-sheeted in the court of Special Judge (Sessions), Mumbai on 1.06.2001 for commission of offences punishable under the sections of IPC and substantive offences thereunder.

### **Major revelations during the investigation**

12.14 The CBI investigation revealed that during the period September 1999 to April, 2000 Shri Ketan Parekh, Shri Kartik Parekh and Shri Kirit Parekh had opened as many as 11 accounts with

the MNCB Ltd., Mandvi Branch Mumbai. The same persons were also holding as many as 16 accounts with Bank of India, Stock Exchange Branch, Mumbai in the names of various companies such as Classic Credit Ltd., Panther Investrade Ltd., Panther Fincap and Management Services Ltd., N.H. Securities Ltd., etc.

12.15 In November 1999, Shri Ketan Parekh and his associates were sanctioned limit of Rs. 20 crores in each account against fixed assets of Ketan Parekh group of companies by the Board of Directors of the Madhavpura Mercantile Co-op. Bank Ltd. chaired by Shri Ramesh Parekh, in utter violation of guidelines of the RBI. In April, 2000 MNCB Ltd. again similarly sanctioned limit of Rs. 20 crores in the names of (a) Chitrakut Computers Pvt. Ltd., (b) Nakshtra Software Pvt. Ltd. and (c) Goldfish Computers Pvt. Ltd. Though, the sanction was against fixed assets, no attempt was made by the Madhavpura Mercantile Co-op. Bank Ltd. officials to take these assets as security nor did they take any collateral security, thereby leaving their exposures unsecured.

12.16 On or about 8.3.2001 and 9.3.2001 in all 13 Pay Orders were obtained from MNCB Ltd. by Shri Kartik Parekh at the instance of Shri Ketan Parekh against the cheques issued from their accounts in the MNCB Ltd., Mandvi Branch, Mumbai. These Pay Orders were signed by Shri J.B. Pandya, Branch Manager, MNCB, Mumbai under the oral instructions of Shri Ramesh Parekh and Shri Devendra Pandya, Chairman and Managing Director of the Bank respectively. At the time of issuing these Pay Orders sufficient balance was not available in the respective accounts in as much as some of the accounts had been overdrawn far beyond the sanctioned limit of Rs. 20 crores. 6 Pay Orders amounting to Rs. 62 crores were presented by Shri Ketan Parekh and Shri Kartik Parekh on 8.3.2001 at Bank of India, Stock Exchange Branch, Mumbai along with application for purchasing/discounting the same. These Pay Orders were purchased by the Bank of India. Similarly on 9.3.2001, Pay Orders worth Rs. 75 crores were obtained from the Madhavpura Mercantile Co-operative Bank Ltd. again without generating funds and were presented in Bank of India for purchase. These were again purchased by Bank of India. When the Pay Orders were sent for clearing on 12.3.2000, the same were returned unpaid as the Madhavpura Mercantile Co-operative Bank Ltd., did not have sufficient funds to honour their commitments and also did not participate in the clearing on that day. Meanwhile, Shri Ketan Parekh and his associates had diverted the funds that had been fraudulently generated to the share broking companies. Due to said acts of omission and commission, while illegal loss of Rs. 137 crores was caused to Bank of India, Shri Ketan Parekh and associates played around in the Stock Market with the same funds.

12.17 The searches were conducted by CBI at 15 places in Mumbai, Ahmedabad and Calcutta on 30.03.2001 and S/Shri Ketan V. Parekh, Jagdish B. Pandya, Kartik K. Parekh, Ramesh Parekh and Devendra Parekh were arrested on 30.03.01, 31.03.01, 31.03.01, 08.04.01 and 20.05.2001 respectively. The CBI in its FIR had alleged that during the month of March, 2001 accused Shri Ketan Parekh and other accused persons had criminally conspired with each other, the object of which was to defraud Bombay Stock Exchange Branch of Bank of India to the tune of Rs.137 crores. On the basis of complaint from Shri G.K. Goel, Chief Vigilance Officer, Bank of India, the Bank Securities and Fraud Cell of CBI, Mumbai registered a case (R.C.3(E)/2001-BS&FC/Mum.) on 30.03.2001. The case was chargesheeted in the court of Special Judge (Sessions), Mumbai on 1.06.01 for commission of offences punishable under sections 120-B, r/w, 420, 467, 468, 471 of IPC and substantive offences thereunder. The accused persons in the chargesheet were S/Shri Ketan Parekh, Kartik Parekh, Kirti Parekh, Ramesh Parekh (then Chairman, MNCB, Ahmedabad), Devendra Pandya (the MD, MNCB, Ahmedabad), J.B. Pandya (then Branch Manager, MNCB, Mumbai). The next date of hearing is on 7.10.2002 for arguments on charge.

(b) Investigation under case RC 4(E)/2001-BS &FC/MUM

12.18 The total amount involved in the case was Rs. 1030.04 crores. In the FIR, it was alleged that the accused in conspiracy with each other dishonestly made advances to several parties to the tune of Rs. 1030.04 crores against the overall permissible limit of Rs. 475 crores by committing breach of directives/circulars/rules & regulations of RBI and by breach of law. The parties who made such advances were illegally and unauthorisedly allowed withdrawal of the funds from their accounts by Shri J.B. Pandya at Mandvi Branch, MNCB, Mumbai at the instance of Shri Ramesh Parekh and Shri Devendra Pandya. There were 11 accounts which belong to Ketan Parekh group in the said list of accounts of parties which were advanced such unauthorized withdrawals. It was further alleged that during the period from 17.01.2001 to 28.02.2001 a total sum of Rs. 135 crores was transferred illegally and unauthorisedly from the account of Panther Fincap Management Services of Ketan Parekh group maintained at MNCB, Mandvi Branch, Mumbai to Shri Ramesh Parekh's account of Madhur Shares & Stocks Pvt. Ltd. (MSS) maintained at MNCB, Ahmedabad by means of telegraphic transfers. MSS further transferred the funds to the tune of Rs. 55.6 and Rs. 13.2 crores to local broker accounts in the name of Rajesh and Javeri and Rajesh Javari Stock Broker Pvt. Ltd. respectively. It is further alleged that for making such illegal and unauthorized advances the accused persons forced the bank to borrow funds in the form of call money from various banks and thereby caused heavy economic burden upon MNCB which ultimately resulted in non-payment of the deposits to the depositors. This borrowing of call money from other banks was to the tune of Rs. 197 crores.

12.19 CBI further informed that the accused Shri Ketan Parekh has since complied with the condition of bail of depositing Rs. 16,41,69,000/- in the Mumbai Branch of MNCB accounts against his dues, as it is the amount of small depositors (of upto Rs. 5000). However, with regard to the second condition of depositing Rs. 380 crores being the amount of small depositors (of upto Rs. 1 lakh), the MNCB has filed a criminal miscellaneous application in the High Court of Gujarat, Ahmedabad praying for cancellation of bail of Shri Ketan Parekh on the grounds that the Learned CMM, Ahmedabad had erred in passing conditional order and that three year time granted for payment of Rs. 380 crores is improper. The case is yet to come up for hearing.

**Alleged Foreign Accounts of Shri Ketan Parekh**

12.20 The Committee were informed by the representatives of CBI that while they were investigating Shri Ketan Parekh's case, information was received that perhaps, he has siphoned off some of his money to a foreign bank. This information was developed and through a contact in Switzerland, it was learnt that he indeed had siphoned off money in a particular bank. In his rejoinder dated 19th July, 2001 filed before the High Court at Mumbai, during hearing of his anticipatory bail application, Shri Ketan Parekh had denied having any funds in any foreign account and disowned having transferred any funds from the country to any destination abroad.

12.21 The Central Bureau of Investigation received a letter dated 26.6.2001 of Examining Magistrate's Office-IV, Canton of Zurich, Switzerland through Interpol *vide* which it was intimated that they had issued criminal procedure against an Indian Citizen named Parekh Ketan based on suspicion of money laundering and forgery. They received information about an account at Credit Suisse in Zurich. Contracting partner of the account is a Corporation named Elista Limited, Nassau, Bahamas and beneficial owner of this account is Shri Ketan Parekh. The mentioned account has been frozen by an order of the Swiss Authorities. In the background aforesaid, the Swiss Authorities enquired if CBI is conducting an investigation concerning Shri Ketan Parekh and is interested in further information concerning this bank account, they may get this information from Switzerland by submitting a request for legal assistance.

12.22 In view of the information received from the Swiss Authorities, the matter of issuance of Letter of Request u/s 166-A Cr.P.C. was taken up with the Court of Ld. Chief Metropolitan Magistrate, Ahmedabad and the court was pleased to issue the same on 25.09.2001. Through the Letter of Request forwarded on 28.9.2001, the Swiss Authorities have been requested to furnish detailed information about the existence of the said account, statement of account, date of opening of the account, source of initial deposit, identity of the person or persons permitted to operate the said account along with the supporting documents and other facts.

12.23 The reply to the Letter Rogatory from the competent authorities of Switzerland is awaited. The CBI also informed that Interpol reference has also been sent to Abu Dhabi for freezing accounts maintained at Merrill Lynch Bank by Shri Ketan Parekh.

#### **OCB connection of Shri Ketan Parekh**

12.24 CBI informed that the interrogation of Shri Ketan Parekh has revealed that some of his relatives are associated with certain OCBs (Overseas Corporate Bodies) which had traded heavily with Shri Ketan Parekh's companies. During evidence, the witness in this regard stated as under:

"We have got some documents from which it is clear that a relation of Shri Ketan Parekh, Shri Amul Shah, is in London where he is managing some OCBs..."

12.25 Subsequently, CBI submitted in a written reply that initially two OCB accounts in the names of Far-East Investment Corporation Ltd. (FEICL) and European Investment Ltd. (EIL) were opened in the year 1997 and 1999 respectively at IndusInd Bank, Mumbai. The overseas promoters of these companies are NRIs residing at Dubai and UK, apart from two Mauritians who appointed the following Indian nationals as Power of Attorneys(POAs) to operate the said accounts with IndusInd Bank, Mumbai:

- (i) Shri Ashok Mittal, Prop. Of Litolier Group, Mumbai.
- (ii) Shri Shishir Diwanji, Solicitor of Desai, Diwanji & Co., Mumbai.
- (iii) Shri Noshir B. Captain, Chartered Accountant, Mumbai

12.26 In the month of November 1999, the said two OCB accounts of FEICL and EIL with IndusInd Bank were closed and transferred to GTB, Fort Branch, Mumbai. Shri Ketan Parekh opened several accounts with the said Branch of GTB where-in huge transactions were carried out with these two OCBs. It has also come to notice that the following OCBs based at Mauritius had also opened their account with GTB:—

- (i) Kensington Investment Ltd., (KIL)
- (ii) Brentfield Holdings Ltd., (BHL)
- (iii) Wakefield Holdings Ltd., (WHL)
- (iv) Rafs Corporation Ltd., (RCL)
- (v) Symphony Holdings Ltd., (SHL)

12.27 The promoters of the OCBs viz., Kensington Investment Ltd., Brontfield Holdings Ltd., and Wakefield Hordings Ltd. are Mr. Thirupathur L.Chandran and Mrs. Meena Chandran, Indian Citizens residing in Singapore. The Mauritius based directors of these companies are Mr. Kapil Dev Joory and Coldip Vasant Lala. These companies were opened in March and April 1999 with paid up capital of US \$550 to US \$ 5000 initially. These accounts namely Kensington Investment Ltd. and

Brentfield Holdings Ltd. were introduced by Shri Ketan Parekh's Triumph International Finance Ltd. (TIFL) which was already maintaining account at GTB, Fort Branch. The OCB account of Wakefield Holdings Ltd., was introduced by Kensington Investment Ltd. Shri Amul Shah who is the brother-in-law of Shri Ketan Parekh first became the POA holder in respect of the OCB account of Kensington Investment Ltd. and subsequently he became an additional signatory in all these three OCB accounts namely Kensington Investment Ltd., Brentfield Holdings Ltd., and Wakefield Holdings Ltd. Investigation is in progress in this regard.

12.28 As regards OCB accounts of Rafs Corporation Ltd. and Symphony Holdings Ltd., the promoters are Suterwallas residing in UK and their foreign directors are Mr. Kee Choongli Kwong Wing, Mr. Amal Arpun Avtar and Mrs. Ah Chin Likwong Wing. The OCB account of Rafs Corporation Ltd. was introduced again by Shri Ketan Parekh's Triumph International Finance Ltd. and OCB account of Symphony Holdings Ltd. was introduced by Rafs Corporation Ltd. Here also the total paid up capital was US \$ 1000. The POA holders of Rafs Corporation Ltd. and Symphony Holdings Ltd. were Shri Darmesh Doshi and Shri Jatin Shah.

12.29 It has also come to notice that another OCB account in the name of Almel Investment Ltd. (AIL) was opened at HDFC Bank Ltd., Mumbai in 1998 in which also Mr. Thirupathur L. Chandran and Mrs. Meena Chandran are directors and the Mauritian directors are the same viz. Mr. Kapil Dev Joory and Coldip Vasant Lala. The paid up capital was also US \$ 5000. The account was introduced by International Finance Services Ltd. of Mauritius. Amul Shah was the POA holder of the accounts.

12.30 The fund flow statements prepared with the help of RBI officials reveals that in respect of 6 OCB accounts that have come to notice, so far there was a total outflow of Rs. 3491 crores. Out of this Rs. 2630 crores was repatriated to the 7 OCB accounts maintained at HSBC, Mauritius and around Rs. 13 crores was repatriated to Almel Investment account at London. Rest of the money was presumably utilized in India. Detailed investigation in this regard is in progress to connect funds of MNCB to the tune of Rs. 1030 crores alleged to have been defrauded.

### **Investigations in respect of UTI/Cyberspace**

12.31 Economic offences wing of CBI, Mumbai registered a case RC3/E/ 2001/EOW/ Mumbai dated 18.7.2001 against Cyberspace Infosys Ltd., its Director Shri Arvind M. Johari and some senior officers of UTI namely Ex-Chairman Shri P.S. Subramanyam, Shri M.M. Kapur, Executive Director (UTI), Shri S.K.Basu, Executive Director (ED) (UTI) and Smt. Prema Madhu Prasad, General Manager (GM) (UTI), and other unknown private persons and other unknown officials of UTI.

12.32 The main allegations in this case are that Cyberspace Infosys Ltd. through its directors mainly Shri Arvind M. Johari entered into a criminal conspiracy with the then Chairman, UTI, Shri P.S. Subramanyam, Executive Directors Shri M.M.Kapur & Shri S.K. Basu and General Manager Smt. Prema Madhu Prasad and others, the object of which was to cause wrongful loss of approx. Rs.32 crores to UTI. In pursuance to the aforesaid criminal conspiracy, the above referred executives of UTI decided to subscribe to 3,45,000 shares of Cyberspace Infosys Ltd. at an exorbitant rate of Rs. 930 per share on private placement basis in July, 2002 against advice of Equity Research Cell of UTI as well as of all the concerned Fund Managers of UTI. The proposal was initially rejected by UTI considering the findings of Equity Research Cell and the concerned Fund Managers of UTI. However within 4 days, the proposal was revived without any request from Cyberspace Infosys Ltd. or new facts having come on record to justify the revival of the proposal. During interrogation even the accused persons have admitted that the sudden reversal of their earlier decision to subscribe to 3,45,000 shares of Cyberspace at the rate of Rs. 930 per share was not a professional decision and was influenced by various extraneous considerations

and therefore, UTI invested an amount of Rs. 32,08,50,000/- in 3,45,000 shares of Cyberspace Infosys Ltd. on 27.7.02. As the share price for private placement was fixed by Cyberspace Infosys Ltd. after manipulating the share price on the Stock Exchange, the market price of the share came down immediately after private placement and the shares were finally delisted from the Stock Exchange in April, 2001 resulting in wrongful loss of Rs. 32,08,50,000/- to UTI.

12.33 The premises of all the accused were searched by CBI and during investigation all accused persons except Smt. Prema Madhu Prasad were arrested and examined in custody. CBI also informed that Shri M.M. Kapur, ED has since expired on 23.9.01

12.34 On being asked, whether CBI found anything illogical or irregular within UTI other than the Cyberspace transaction, the CBI stated as under:

"...we probed the UTI conduct with regard to Cyberspace case only. We examined the documents relating to the decision they took with regard to Cyberspace case. There was certainly something highly irregular. First, they took a decision not to purchase the shares. Second, the decision was reversed the very next day. So, that is something highly irregular. As I mentioned, we have focused ourselves only with regard to this case."

12.35 To a further query, the witness deposed:—

"...there were three persons primarily who were a part of the decision-making process. One was Mr. Subramanyam, the second one was Mr. Kapur and there was another gentleman, Mr. Ghosh. These were the three persons."

12.36 As per a self contained note on investigation submitted by CBI, the case was registered on the basis of source information developed by CBI for investigation of offences of criminal conspiracy, criminal breach of trust, cheating and criminal misconduct on the part of the accused persons. In addition to the accused mentioned above, Shri Rakesh Mehta a share broker was added as accused during investigation.

12.37 CBI in its latest status report dated 17.9.02 has submitted that the investigation of the case has almost been completed and major findings from the revelations are as under:—

- (i) The initial decision of UTI, which was approved by Chairman on 17.07.2000 to refuse offer of Cyberspace Infosys Ltd. to subscribe to the issue of private placement of shares at the rate of Rs. 930 per share was professionally sound and in conformity with the recommendation of Equity Research Cell of UTI and decisions of Fund Managers of different schemes of UTI.
- (ii) The initial decision of not subscribing to shares of Cyberspace on private placement, was suddenly reversed on 21.07.2000 by Shri P.S. Subramanyam, the then Chairman, UTI without any reason. For the purposes of reversal of decision Smt. Prema Madhu Prasad, General Manager, UTI had put up a misleading note, in prior consultation and connivance with Late Shri M.M. Kapur, Executive Director and Shri S.K. Basu, Executive Director and Shri P.S. Subramanyam recommending investment of approximately Rs. 32 crores in shares of Cyberspace Infosys Ltd. at exorbitantly higher price of Rs. 930 per share.
- (iii) Certain alterations and manipulations were made in the note sheet to justify the decision and to show that the decision was taken due to commercial expediency.
- (iv) Even terms of the sanction of investment were not complied with and funds were released by further relaxing the terms.

- (v) The entire amount of Rs. 32,08,50,000/- released by UTI was not utilized for acquisition of business (in software sector abroad) as was stipulated in the offer document by Cyberspace Infosys Ltd. but the same was diverted to Stock Exchange through a circuitous route, involving large number of Banks and accounts, to meet the obligations of Group Companies of Cyberspace Infosys Ltd. as well as for purchase of shares of Cyberspace Infosys Ltd. by different entities of the Johari Group i.e. promoters of Cyberspace Infosys Ltd., to maintain the share price of Cyberspace Infosys Ltd., at higher level with a view to dispose the shares in future at a profit, thus subjecting the investors to loss.

12.38 One of the important aspects of investigation in this case was to establish that the share prices were artificially manipulated by the management of Cyberspace Infosys Ltd. in connivance with Shri Rakesh Mehta, a Share Broker, (who has been added as an accused in this case during investigation), and other brokers with a view to charge higher premium from financial institutions and Banks in private placement. This allegation is being enquired in consultation with SEBI.

12.39 The CBI also informed in a post-evidence reply that the end-use of amount of approx. Rs. 27.64 crores out of total amount of Rs. 32.08 crores has been identified, out of which approx. Rs. 21 crores has been paid to Bombay Stock Exchange through accounts of various companies of Johari Group towards purchase of shares of Cyberspace i.e. shares of their own company with a view to prevent fall in share prices. It was also revealed during investigation that there were no takers in the market for issue of equity on private placement by Cyberspace. For the purpose of marketing the issue, the company had approached SBI Capital Markets Ltd., and UTI Securities Exchange Ltd. to act as 'arrangers' to the issue. Both of them together had approached 61 prospective institutional investors with an offer for private placement of equity at the rate of Rs. 930/- per share on behalf of Cyberspace. Except UTI, either these institutions did not respond to the offer or they responded in a negative manner, highlighting the negative features of the proposal. Still UTI, which is expected to be manned by professionals having expert knowledge in the field of equity investment subscribed to the issue, ultimately leading to loss of more than Rs. 32 crores to UTI.

12.40 Investigation has also revealed that criminal conspiracy to defraud the mutual funds, banks and general public etc. was conceived by directors of Cyberspace Infosys Ltd. way back in April 1998 when they suddenly changed the name of company from Century International Finance Ltd. to Cyberspace Infosys Ltd. to take advantage of infosys boom in the share market. The share price of Century International at the share markets was quoting at less than Rs. 15/- in April 1998. As a result of change of name and price manipulation it went upto approx. Rs. 100/- within a few months and by Feb. 2000 it crossed to Rs. 1200/- per share. The allegation of price manipulation is being investigated by SEBI who are competent to do this.

#### **Investigations pertaining to City Cooperative Bank Ltd., Lucknow and Century Consultants Ltd.**

12.41 In relation to City Cooperative Bank Ltd. (CCBL) and Century Consultants Ltd. (CCL) scam, the CBI registered a total of 11 cases. These cases were initially registered at Police station — Hazratgang, Lucknow. On the request of Government of Uttar Pradesh, investigation of the above cases was taken over by CBI, Lucknow.

#### **(a) City Cooperative Bank Ltd. (CCBL)**

12.42 CBI had registered two cases, i.e. RC.19(S)/2001-CBI/Lucknow and RC.20(S)/2001-CBI/Lucknow pertaining to City Cooperative Bank Ltd., (CCBL) Lucknow. During oral evidence CBI had informed that it had registered a number of cases in Lucknow branch including the one

on City Cooperative Bank Ltd. (CCBL) and also the fraud committed by Century Consultants set up by Johari Brothers. Unfortunately again, because of the resource crunch, it could not finalise those investigations till then. Those investigations are on and in another three-four months' time, the CBI can finalise them.

12.43 Thereafter, the CBI submitted a self-contained note on cases RC.20(S)/2001/CBI/CKO and RC19.(S)/2001 in respect of City Cooperative Bank.

#### Investigation in respect of case no. RC.20(S)/2001/CBI/LKO

##### Allegations

12.44 It has been alleged that Shri Gorakh Nath Srivastava, the then Secretary, City Cooperative Bank Ltd., Lucknow by misusing his official position, purchased nine number of cheques worth Rs. 1,71,35,000/- during February-March, 2001 issued by the group companies of Shri Anand Krishna Johari in favour of the other group companies of Shri Johari namely Country Informtech Services Pvt. Ltd. and Kamal Infosys Pvt. Ltd. Shri Gorakh Nath Srivastava did not send the cheques for clearing even after disbursement of the proceeds. When the cheques were sent for clearing after his suspension, same were returned unpaid for want of balance in the respected accounts.

##### Outcome of the Investigation

12.45 Investigation of the case could be concluded on 13.11.2001 and charge sheet in the court of law was filed against S/Shri Gorakh Nath Srivastava, Anand Krishna Johari, Arvind Mohan Johari and S.N. Mishra u/s 120-B, 420, 467, 468 and 471 IPC on 13.11.2001. Regular departmental action for major penalty has also been recommended against Shri Shrinivasa Rao, Officer, State Bank of Hyderabad, Lucknow for his departmental misconduct.

12.46 Investigation has revealed that Shri Gorakh Nath Srivastava functioned as Secretary, City Cooperative Bank Ltd., Lucknow during the period 02.07.94 to 21.4.2001 i.e. from inception of the Bank till his suspension on 21.04.2001. Shri Anand Krishan Johari was the Director, City Cooperative Bank Ltd., Lucknow since the election of Board of Directors held in August, 1996 till suspension of the Board on 9.4.2001 by the Govt. of UP. He was also one of the directors of Century Consultants Ltd. Shri Arvind Mohan Johari was also a director of Century Consultants Ltd. and Kamal Infosys Ltd. during the relevant period.

12.47 As per the provisions contained in the Bye-Laws of City Cooperative Bank Ltd., Lucknow Shri Gorakh Nath Srivastava, the then Secretary, City Cooperative Bank Ltd., was empowered to sanction loan upto Rs. 15,000/- at a time against pledge of approved securities which were required to be confirmed by the Board of Directors of City Cooperative Bank Ltd., Lucknow. He was not competent to sanction any clean limit to any one. No cheque purchase limit was sanctioned by the Board of Directors of City Cooperative Bank Ltd., Lucknow in favour of Country Informtech Services Pvt. Ltd. and Kamal Infosys Pvt. Ltd. Therefore, Shri Gorakh Nath Srivastava was not competent to permit purchase of any cheque presented by these two companies.

12.48 Investigation has revealed that in contravention of Section 20(1) of Banking Regulation Act, 1949 this bank has disbursed various loans/over draft facilities to companies belonging to Shri A.K. Johari, Director, City Cooperative Bank Ltd. and his family members. Shri A.K. Johari, being director of City Cooperative Bank Ltd., and his family members were not entitled to avail any cheque purchase facility/loan from City Cooperative Bank Ltd.

12.49 Investigation has confirmed that Century Consultants Ltd., Kamal Infosys Ltd., Tirupati Financial Services Pvt. Ltd. and Country Informtech Services Pvt. Ltd. are group concerns of Shri A.K. Johari and Shri A.M. Johari. Hence, issuance of cheques from the account of one company to the account of another company was merely a fraud on the Bank with the malafide intention of siphoning off the funds.

12.50 After the purchase and disbursement of the proceeds, the aforesaid 9 cheques were detained by Shri Gorakh Nath Srivastava in his personal custody and he did not allow the same to be sent for clearing except one cheque which was sent for clearing but returned unpaid on 14.03.2001.

12.51 The above mentioned amount of Rs. 1,71,35,000/- is still outstanding. Investigation has proved that the entire cheque purchase proceed of Rs. 1,71,35,000/- was utilized by Shri A.K. Johari and Shri A.M. Johari for furthering their business interest. The case is pending under trial in the Court of Special Judicial Magistrate, Lucknow.

#### Investigations in respect of case no. RC/19(S)/2001/CBI/LKO

12.52 Investigation in this case was taken over by Lucknow branch of CBI from State Police on 6.7.01 and it is still in progress.

#### Allegations

12.53 It is alleged that Shri Anand Krishna Johari, director, City Cooperative Bank Ltd. (and director of Century Consultants Ltd.), Lucknow, entered into criminal conspiracy with Shri Gorakh Nath Srivastava, the then Secretary of City Cooperative Bank Ltd., Lucknow and in pursuance thereof defrauded City Cooperative Bank Ltd., Lucknow by getting transferred Rs. 2 crores *vide* telegraphic transfer in favour of Century Consultants Ltd. A/c Mumbai through State Bank of Hyderabad. Further Rs. 17.42 crores were debited from the City Cooperative Bank Ltd., account in the name of fictitious investments in criminal conspiracy with both of them. In furtherance of the said criminal conspiracy S/Shri Anand Krishna Johari and Shri Gorakh Nath Srivastava have withdrawn Rs. 6.34 crores in the name of fictitious/bogus loans and have defrauded City Cooperative Bank Ltd., Lucknow to the tune of Rs. 25.76 crores and benefited themselves.

#### Outcome of Investigation

12.54 Investigation of the case so far has revealed that S/Shri A.K. Johari, A.M. Johari and Gorakh Nath Srivastava in criminal conspiracy with each other have fraudulently got transferred about Rs. 29 crores from City Cooperative Bank Ltd., Lucknow by showing fictitious investments and bogus loans in their records either directly to the account of Century Consultants Ltd., or by adopting via-media of third accounts for transferring the amount to the account of Century Consultants Ltd., Most of the documents proving transfer of funds from the account of City Cooperative Bank Ltd, Lucknow to different accounts in the name of fictitious investments and bogus loans have been collected. The documents proving ultimate end use and beneficiary of funds so transferred have also been collected. Bogus loans amounting to Rs. 817.07 lacs in the name of 25 parties/persons associated with Shri A.K. Johari were sanctioned and disbursed at City Cooperative Bank Ltd. without giving any security and without observing any prescribed norms. The entire amount was transferred ultimately in favour of Century Consultants Ltd., and utilized by them.

12.55 Investigation of the case is still in progress. Collection of evidence to prove complicity of the accused persons is in progress.

## **(b) Century Consultants Ltd. (CCL)**

12.56 CBI informed the Committee that initially 11 cases were registered at Police Station Hazaratganj, Lucknow i.e. RC.8(S)/2001-CBI/Lucknow to RC.12(S)/2001-CBI/Lucknow and RC.15(S)/2001 to RC.20(S)/2001-CBI/Lucknow. The cases were taken over by CBI, Lucknow on the request of the Government of Uttar Pradesh for investigation.

12.57 As per the latest status report dated 17.9.02 submitted by CBI, since the main accused persons named in the FIRs in cases RC.8(S)/2001 to RC. 12(S)/2001 and RC 15/S/2001 to RC.18(S)/2001/CBI/LKO i.e. a total of 9 cases are common, allegations are similar in nature, modus operandi adopted by the accused is the same and the documents and witnesses are common, the investigation has been conducted jointly under case file of RC. 8(S)/2001/CBI/LKO. These cases were registered on the basis of complaints lodged by different persons/individuals against the company, its directors and officials/employees.

### Allegations

12.58 The allegations against the accused pertained mainly to cheating and duping investors of their money through operating several investment schemes by Century Consultants Ltd. and its directors.

### Outcome of Investigation

12.59 The investigation in respect of the following investment schemes of Century Consultants Ltd., Lucknow namely (i) Byaj Badla Scheme (ii) Century Secured Bonds and (iii) Cyberspace Fixed Deposits Scheme related to Cyber Infosys Ltd., has already been completed and a chargesheet under sections of IPC has been filed against S/Shri G.N. Johari, A.M. Johari, A.K. Johari, Paradip Narain, A.K. Shah, all of Century Consultants Ltd. and Cyberspace Infosys Ltd. through their Chief Executives/Directors and the same is pending trial.

12.60 The investigation by CBI has disclosed that Century Consultants Ltd. allured the individual investors to invest money under Byaj Badla Scheme floated by Bombay Stock Exchange making them believe that the amount invested under this scheme is fully safe and secured and amount invested by them shall be utilized for purchasing shares of 'A' Group Companies. It was also assured that investors can withdraw themselves from the scheme by giving a week's notice. The Century Consultants Ltd., was required to invest the amount collected from the investors under Byaj Badla Scheme with BSE and in lieu of investment a contract note was required to be issued to the investor by them. The Century Consultants Ltd. intentionally did not invest the money so collected with BSE and no contract note was ever issued to the investors. Investigation has further revealed that under Byaj Badla Scheme a sum of Rs. 15,73,98,049/- of 1138 investors is still outstanding for payment by Century Consultants to the investors. It has been revealed that the said amount has been dishonestly and fraudulently utilized by S/Shri Gorakh Nath Johari, A.M. Johari and A.K. Johari, directors of Century Consultants for their own illegal use and thus the investors stand cheated as the amount entrusted by the investors on the inducement of aforementioned accused persons to Century Consultants Ltd., on the pretext of investments under this scheme was not paid back to the said investors.

12.61 Investigation has further disclosed that Century Consultants Ltd. floated a scheme 'Century Consultants Ltd. Secured Bond' on private placement basis during the period 1997 to 2000. The Century Consultants Ltd., with the connivance of persons mentioned in the FIR received/obtained a sum of Rs. 3,62,59,000/- from 2102 investors on the false pretext as well as on the basis of bogus documents and dishonestly and fraudulently misutilised the amount so collected for their own use and thus the investors stand cheated.

12.62 Investigation also revealed that S/Shri Gorakh Nath Johari, A.M. Johari and A.K. Johari through their company Cyberspace Infosys Ltd. floated a scheme i.e. 'Cyberspace Fixed Deposit' in which the company accepted the deposit of Rs. 11,46,23,652/- from 5971 investors. Whereas the company was authorized to collect the deposit to the tune of Rs. 5,17,83,750/- only as per the mandatory provisions of company deposit and acceptance rule 1975. The money collected by giving false information/statement/advertisement was misutilised by S/Shri Gorakh Nath Johari, A.M. Johari and A.K. Johari and also used in the insider trading of Cyberspace shares which is prohibited under the law.

12.63 Investigation in respect of other aspects of allegation involving investment in the following schemes of Century Consultants Ltd. and its other group companies is still under investigation.

1. Century Consultants Ltd. (Equity Scheme)
2. Century Consultants Ltd. (Preferential Shares Scheme)
3. Century Consultants Ltd. (Preferential Shares Scheme)
4. Century Consultants Ltd. (Equity Scheme)
5. Century Consultants Ltd. (Preferential Shares Scheme)
6. Century Consultants Ltd. (Preferential Shares Scheme)
7. Kamal Infosys (Equity Scheme)

12.64 The investigation in relation to Kamal Infosys Ltd. (Equity shares) has revealed that the company was not authorized to raise the equity capital by way of shares to the tune of Rs. 2.32 crores. However, the company fraudulently and dishonestly by duping the investors had raised the equity share capital to the tune of Rs. 2.32 crores by unauthorizedly issuing share certificates to the investors on private placement basis. The amount so collected under this scheme has been misutilized by the directors of Kamal Infosys Ltd. and others in conspiracy with each other. The investigation of the case is complete and the matter is under legal scrutiny.

### **Resource Constraints in CBI**

12.65 During evidence on being asked whether CBI is considering broadening the focus of investigation of the scam, the witness deposed as under :

"...We wish we could do all that you have in mind but our resources do not permit us. We have today 50 per cent vacancies in the CBI. Each scam means very wide ramification, involves a lot of work and it takes years. In dealing with one case, CBI takes a very long time to investigate. As a CBI officer and as a citizen of the country, I am aware that a lot is happening which needs to be identified, need to be taken action again. There is no doubt about it that Century Consultants, Cyberspace case, Madhavpura Mercantile Bank are not the only scams that have taken place in the country. I am sure there are many such things happening in the country. CBI certainly has no inputs."

12.66 With regard to constraints faced on account of manpower in CBI, the witness informed as under :

"Whether it is Economic Offences Wing (EOW) of the CBI, whether it is Banking Securities Fraud Cell of the CBI or whether it is Special Crime Division of the CBI, there is a shortage."

12.67 Subsequently, in a written reply submitted by CBI, it was informed that there are 236 sanctioned posts of Deputy Superintendent of Police in the CBI. As on 31.12.2001, 124 were

occupied and 112 were vacant. Of these 112 vacancies, 96 were against deputation quota and 21 against promotion quota. (The figure of 112 is arrived at after taking into consideration 5 DSPs in excess in the direct recruitment quota). CBI further informed that all the vacancies under the promotion quota have been filled up and fresh advertisement issued in April, 2002 for filling up the deputation vacancies in CBI.

12.68 In this regard, the Department of Personnel and Training also submitted that in CBI, no posts were created by the Government on the basis of cadre review. The posts in CBI were created by the Government in various ranks as and when need arose or due to the increase in the number of cases registered and requirement of additional staff based on proper justifications. In pursuance of the directions of the Supreme Court, 230 posts were created in the Special Crimes Division and the Economic Offences Division in CBI within the period December 1998 and April, 2002.

### **Combating the Growing Incidence of Financial Frauds**

12.69 CBI submitted that the weakness of the Criminal Law and Criminal Jurisprudence is writ large in the administration of Justice in India. The common law pressure on Justice delivery system on account of 'Proof beyond doubt' is very heavy specially in the offences relating to finance. The nation is suffering from a serious 'crisis of confidence'. No one can repose faith in others including entities and institutions. Financial fraud per-se is not an offence, inspite of the fact that the banks, financial institutions and the common investors suffer heavily in frauds committed by the borrowers in collusion with employees of the banks and financial institutions and by various financial intermediaries in dubious financial schemes respectively. Added with this weakness is the weakness in the administration of Criminal Justice.

12.70 CBI in this regard also submitted on 10.6.2002, a copy of Research Paper on Economic Crimes or Financial Frauds to the Committee on Reforms of Criminal Justice System set up by the Government under the Chairmanship of Justice V.S. Malimath.

12.71 CBI further submitted that in view of the complex and diverse nature of transactions in the financial world, it is essential to strengthen the Bank Securities and Fraud Cell and Economic Offences Wing of the CBI by inducting experts from various fields like Chartered Accountants/ Cost Accountants, Bankers, Capital Market Experts and Attorneys having a background in the financial matter. There is also a need for setting up Special Courts for trial of offences relating to financial frauds on the lines of the Special Courts set up in pursuance of Special Courts (Trial of offences relating to transaction in Securities) Act, 1992. Similar specialized Multi Disciplinary Agencies also need to be set up by the various States for investigation and prosecution of financial frauds in their respective jurisdictions.

12.72 As per the Expert Committee appointed by the Reserve Bank of India to suggest ways and means for dealing with financial frauds under the Chairmanship of Dr. N.L. Mitra which submitted its report to Governor, RBI in August, 2001, the financial fraud, in itself, is not an offence in India. The Committee suggested two types of steps to deal with this serious national problem viz. prohibitive and preventive. The Committee suggested that:

- “(i) Financial fraud, which is essentially committed with public fund by the contracting parties, be criminalized by suitably amending Indian Penal Code, Criminal Procedure Code and Indian Evidence Act. A special multidisciplinary investigating agency be constituted to investigate serious financial frauds above rupees ten crores and a Special fast track court be established to deal with the offence.

- (ii) The Regulatory authorities in the financial system shall have to have a stricter discipline by insisting best practice code for the players and Self Regulatory Organisations (SROs). There shall also be stricter administration of procedures and guidelines laid down by the Regulatory authority. Systemic training and internalizing the rules of procedure and guidelines must be ensured. Legal compliance has to be always insisted upon in dealings with public funds."

12.73 The Report of the Expert Committee also mentions about the need for a separate multi-disciplinary investigating agency for investigating into the affairs of serious financial frauds and the necessity of having a separate Act to deal with financial and banking frauds on the lines of Criminal Justice Act, 1987 of England. The Committee had expressed that the Indian Parliament has Legislative Competence to create financial fraud as a federal offence applicable throughout the country and that there is no Constitutional barrier for creation of a new agency for investigation of financial frauds by the Indian Parliament. The Committee had thus recommended the establishment of a separate Office of Director for investigation of financial fraud and a multi-disciplinary body under his chairmanship. The office must have sufficient number of experts from various fields into its investigating team. The investigation team shall have all powers as provided under Criminal Procedure Code. The Committee in this regard also suggested creation of a separate statute/Act to deal with financial frauds and making financial frauds a criminal offence by suitably amending the relevant laws.

12.74 The Committee note that out of the 72 cases registered by CBI in relation to the 1992 Security Scam, 42 cases were charge sheeted, out of which only 6 cases could be disposed of and the rest are pending trial. One of the reasons contributing to this delay is that initially only one Special Court was set up and subsequently, although four more Courts were set up, but only two courts were really functional. It is really shocking that the situation remains the same even as on date. The Committee desire that this aspect needs to be taken up and resolved with a sense of urgency so as to ensure that the laws are ultimately implemented effectively and the guilty punished in an expeditious manner.

12.75 In regard to 27 lakh missing shares of Harshad Mehta pertaining to 90 companies, the Committee are concerned to note that this was brought to light in the year 2000 by the custodian although all the properties, movable or immovable had been notified by the Custodian way back in the year 1992 itself. The Committee find that it is not clear as to whether the missing shares were discovered by the Custodian while taking stock of all the notified properties of Shri Harshad Mehta or it was Shri Harshad Mehta who informed the custodian about these missing shares. The Committee find that this aspect is also being investigated by the CBI. They desire that the enquiry in this regard be completed at the earliest.

12.76 The Committee find that in case No. RC.3(E)/2001, which pertains to causing a wrongful loss to the tune of Rs. 137 crore to the Bank of India, CBI has filed a charge sheet in the Court of Special Judge, Mumbai on 1.6.2001 against Shri Ketan Parekh, Shri Kartik Parekh, Shri Kirti Parekh, Shri Ramesh Parekh (the then Chairman, MMCB, Ahmedabad), Shri Davendera Pandya (MD, MMCB Ahmedabad), Shri J.B. Pandya (then Branch Manager, MMCB, Mumbai). Another case No. RC 4(E)/2001 has also been registered on the orders (dated 2.5.2001), of the Hon'ble High Court of Gujarat by CBI against Shri Ramesh Parekh, Ex-Chairman, MMCB, Shri Devendera B. Pandya, MD, MMCB and Shri Jagdish Pandya, Branch Manager, MMCB Ahmedabad U/S 120-405,406,408,409,420 IPC & U/S 35(A) of the Banking Regulation Act, 1949 for conspiring together and making illegal advances to the tune of Rs. 1030.04 crores against the overall limit of Rs. 475 crores by committing breach of law and various circulars/directives/rules and regulations of RBI. The charge sheet in this case has not been filed so far. The Committee have also been informed that the Interpol reference has also been sent to Abu Dhabi for freezing the accounts of

Shri Ketan Parekh maintained at Merill Lynch Bank and his alleged Swiss account is also being investigated. It has also been established that Shri Ketan Parekh had opened several accounts with the Fort Branch of GTB and carried out huge transactions with some of the OCBs having a meagre paid up capital of US \$550 to US \$5000, for pumping substantial amount of money into the stock market. The exact amount of money which has been used in India after having repatriated some amount to the OCBs accounts maintained outside India, particularly at Mauritius, is still being ascertained. Detailed investigation to connect funds of MNCB to the tune of Rs. 1030 crores alleged to have been defrauded is also reported to be in progress. The Committee desire that the investigations in this regard should be completed expeditiously. Since the judicial process is a long drawn process, the Committee desire that the cases which have already been filed or likely to be filed in the Courts by the CBI, should be tried by the Special Courts, so that the guilty are brought to book expeditiously. The Committee hope that the issue of setting up adequate number of Special Courts will be taken with due seriousness and with a sense of urgency by the Government, and will not meet the old fate at least this time.

12.77 Economic offences wing of CBI had registered a case against Cyberspace Infosys Ltd., its Director Shri Arvind Johari, some senior officers of UTI namely Ex-Chairman Shri P.S. Subramanyam, Shri M.M. Kapur & Shri S.K. Basu, Executive Directors, and Smt. Prema Madhu Prasad, GM and some private persons and other officials of UTI on 18.7.2001, for causing wrongful loss of approximately Rs. 32.08 crores to UTI, by way of subscribing to 3,45,000 shares of Cyberspace Infosys Ltd. at an exorbitant rate of Rs. 930 per share on private placement basis against the advice of their own Equity Research Cell. The Committee take serious note of the fact that although, as per the status report submitted by the CBI on 17.9.2002 the case is still under investigation and the charge sheet has yet to be filed, even when a period of more than a year has already elapsed. The Committee urge that the CBI must make an earnest effort to complete the investigation without further loss of time.

12.78 In the case of City Co-operative Bank Ltd., Lucknow, CBI had registered two cases i.e. RC.19(S)/2001 and RC. 20(S)/2001. In the former case it has been alleged that Shri Anand Krishna Johari, Director, City Co-operative Bank Ltd., Lucknow entered into criminal conspiracy with Shri Gorakh Nath Srivastava, the then Secretary of the City Co-operative Bank along with Shri Arvind Mohan Johari and in pursuance thereof defrauded the Bank to the tune of approximately Rs. 29 crores by fraudulently transferring this amount to the account of the Century Consultants Ltd., in which both Shri Anand Kumar Johari and Shri Arvind Mohan Johari happened to be Directors by showing fictitious investments and bogus loans in their records and thus benefited themselves. It has also been alleged that bogus loans amounting to Rs. 817.07 crore in the name of 25 parties/persons associated with Shri A.K. Johari were sanctioned and disbursed at the City Co-operative Bank without giving any security and observing any prescribed norms. The entire amount was transferred ultimately in favour of Century Consultants Ltd. The investigation in this case is reported to be still in progress. In the second case viz. RC 20(S)/2001 the allegations are that Shri Gorakh Nath Srivastava, the then Secretary, City Co-operative Bank Ltd., Lucknow by misusing his position purchased nine cheques amounting to Rs. 1,71,35,000 during Feb-March, 2001 issued by the group companies of Shri Anand Krishna Johari in favour of his other group companies. He did not send these cheques for clearing even after disbursement of the proceeds. When these were sent for clearing the same were returned unpaid for want of balance in the respected accounts. Investigations in this case by CBI revealed that the entire proceed of Rs. 1,71,35,000 was utilised by Shri A.K. Johari and Shri A.M. Johari for furthering their business interest. The charge sheet against Shri Gorakh Nath Srivastava, Shri Anand Krishna Johari, Shri Arvind Mohan Johari and Shri S.N. Mishra has since been filed on 13.11.2001 in the Court U/S 120-B, 420, 467 and 471 IPC. Besides, regular departmental action for major penalty has been recommended against Shri Srivastava Rao, Officer, State Bank of Hyderabad, Lucknow for his departmental misconduct. Taking into account the seriousness of the allegations, the Committee

desire that investigations in case No. RC19(S)/2001 be completed as early as possible so that prosecution proceedings could be launched against the accused for having defrauded the Bank and the public at large in a dubious manner.

12.79 The Committee were informed by CBI that in the case of Century Consultants Ltd. the cases were registered on the basis of the complaints received from different investors against the Company and its Directors. The main allegations pertained to duping the investors by way of floating different investment/fixed deposit schemes by Century Consultants Ltd. and its group Companies. According to CBI, since in respect of all these cases, the accused are the same, allegations are similar in nature, modus operandi by the accused is also the same and the documents and witnesses are common, the investigation has been conducted jointly under case file RC 8(S)/2001. In the case of three schemes, the charge sheet has already been filed by CBI and in the case of others, the investigation is still in progress. In view of the similarity of allegations, common modus operandi, documents, witnesses etc., the Committee desire that in the remaining cases also the CBI should conclude the investigation speedily and take necessary follow-up action, particularly in the light of the fact that the interest of small investors is deeply involved.

12.80 The Committee find that human resource constraint has been almost a perennial problem in the CBI, as during the course of the enquiry of the earlier JPC also, the same problem was spelt out. The Committee are however, concerned to note that the situation has not improved even after a lapse of almost a decade, since even at present about 50% vacancies exist in the CBI, including its Economic Offences Wing, which is a crucial arm of the investigative agency. Though it is imperative that a premier investigative agency like the CBI should not be allowed to remain incapacitated for want of both men and material, but at the same time the Committee find that basically CBI is a police organization and is not fully equipped with competent and qualified personnel for investigating into intricate financial matters. This handicap has also been expressed quite explicitly by the representatives of the CBI before the Committee. Taking into account, the new technological innovations where electronic modes are likely to be adopted for undertaking various types of financial transactions, it is imperative that persons investigating the economic offences are fully qualified and trained to handle the complex and diverse nature of transactions with a sense of competence and necessary acumen. The Committee find that the Expert Committee on Legal Aspects on Bank Frauds set up under the Chairmanship of Dr. N.L.Mitra in their report submitted on 31.8.2001 to RBI have also, after having delved deep into the matter, observed that on account of involvement of CBI in multifarious activities, it would be prudent to have a separate multi-faculty investigative institution to deal with financial frauds. The Committee are given to understand that the Government is also seriously pondering over the issue and setting up a separate Serious Fraud Office on similar lines as in the United Kingdom (U.K.). The Committee are inclined to agree with this current thinking and recommend that a separate body be set up to investigate into all incidents of serious frauds and necessary legislation in this regard be enacted. Besides, the jurisdictional powers of such an organization should not be limited to conducting investigation against the employees of the Central Government/Public Sector Undertakings of the Government of India but should be comprehensive, covering offences committed even by the employees of the State Governments/organizations as well as those who are in the private sector.

## 2. DIRECTORATE OF ENFORCEMENT

12.81 The main thrust of enquiry by the Enforcement Directorate was confined to ascertaining the possibility of any FERA/FEMA violations in respect of tracing the sources of funds credited in the accounts of FIs/Sub-Accounts/OCBs which were routed into the Indian Stock Markets as a result of rigging of prices of certain scrips and other manipulations indulged in by the brokers and promoters of certain companies. The investigations were mainly centered around the major

players/entities which played a central role in the present scam. Most of the action by this Directorate commenced after the scam surfaced and therefore this Chapter is relevant for future only. The details of the investigations carried out are detailed below:—

### **Investigations in respect of FIs/Sub-Accounts/OCBs and GTB**

12.82 There are more than 500 FIs and nearly 1400 sub-accounts of FIs registered with SEBI. There were over 700 OCB accounts which had permission to transact under Portfolio Investment Scheme(PIS) in the Indian Stock Markets. Investigations against the OCBs were started by the Directorate from the first week of March but firm action on which the Directorate could build up their own investigations started only after SEBI's report was received by them which was in June, 2001.

12.83 Instances of non-adherence of RBI guidelines by the OCBs are as under:—

- (a) Transactions of OCBs with OCBs and with Indian entities other than through registered stock brokers.
- (b) Sale and purchase of shares by OCBs without actual deliveries.
- (c) Purchase of shares by OCBs on adjustment basis without fund flow from their accounts to brokers' accounts.
- (d) OCBs booking purchase orders without sufficient balances in their respective accounts.
- (e) Exceeding the 5% limit as prescribed for individual OCBs.
- (f) Violations of 10% aggregate ceiling norm for OCBs/NRIs in certain Indian companies.
- (g) Net outflow from the accounts of the said OCBs outside India.

12.84 SEBI in its third Interim Report had also pointed out that the trading pattern of these OCBs revealed that these entities concentrated in a few scrips. Besides, instances of circular trading and parking of shares were also noticed. The outgo of the funds through OCBs was substantial. Ketan Parekh entities misused the FI sub-accounts and OCBs for market manipulations, building of concentrated positions, creating artificial market, circular trading, circumventing takeover regulations, issue of Participatory Notes, etc. SEBI further reported that through its investigations it was revealed that a large number of OCBs (around 550) invested in the Indian Capital Market through the Portfolio Investment Scheme. Further, OCBs have been operating from various tax havens such as British Virgin Islands, Panama, Isle of Man, etc. Mauritius has been the favourite place for more than 80% of these OCBs which are registered there. A large number of OCBs operated from common addresses. It was also gathered that these addresses, shown as registered offices of the OCBs actually belong to Chartered Accountant Firms which provide financial services to these OCBs. It is suspected that certain unscrupulous persons residing in India were/are operating behind these OCBs and certain Indian promoters were also using these as their front offices. Investigations further showed that the facility of investment in the capital market and automatic repatriation of sale proceeds may have been misused by some of these OCBs. Though some of these OCBs had only very nominal share capital (ranging from \$1 to \$10,000), their investment in the Indian capital market was very large running into millions of dollars. It was also seen that net remittances of these select OCBs during the period April 1, 1999 till March 31, 2001 were approximately Rs. 3850 crore.

12.85 The Directorate during their investigations examined Shri Yashpal Kumar under section 37 of FEMA, 1999 and his statement was recorded on 8.10.2001. He had stated that he practices as a chartered accountant and handles the matters of Kensington Investments Ltd., Wakefield

Holdings Ltd. and Brentfield Holdings Ltd. and these OCBs belong to Mrs. and Mr. Chandran, resident of Singapore having their registered office in Mauritius and that he has the power of attorney in respect of these OCBs. He further stated that the clients normally place orders directly with the brokers of their choice and based on their orders the contract notes are received in his office which are reported to the bank forthwith. Subsequently, he coordinates with the brokers for settlement. In respect of Kensington Investments Ltd., Wakefield Holdings Ltd. and Brentfield Holdings Ltd., they are not making payments to brokers or delivering shares. Instructions in this regard are directly given to the bank by the client by fax. Shri Noshir B. Captain, POA holder for the European Investments Ltd. and Far East Investment Corporation Ltd. was also examined under the provisions of FEMA. He stated that he is the POA holder since 1997 for these OCBs and Mr. Seesaram and Mr. Veeraswamy were the Directors of these OCBs and were residents of Mauritius and that these OCBs were dealing with Triumph Securities Ltd. and Triumph International Finance India Ltd. Shri Jatin Sarvaiya, MD of Triumph International Finance India Ltd. was questioned about Rafs Corporation Ltd. and Symphony Holdings Ltd. He explained that these OCBs belong to Mr. Fakruddin Sutarwala and his son Salim.

12.86 Consequent to their snap inspection of Global Trust Bank (GTB), RBI also had on 16.8.2001 referred following irregularities to the Enforcement Directorate:—

- (a) On several occasions OCBs had booked purchase orders without having sufficient balance in their NRE accounts.
- (b) The OCBs had made payments by debit to their NRE accounts but shares had not been received by them.
- (c) Some OCBs had received shares but not made the payments
- (d) Some OCBs had sold the shares but they had not received the payments.

12.87 In order to identify the FIs/Sub-Accounts/OCBs investments in Indian Stock Market, references were made by the Enforcement Directorate to all the 12 Authorised Custodians of FIs/Sub-Accounts/OCBs calling for detailed information about the Stock Market transactions by them from 1.11.1999 onwards. Information/documents were requisitioned and received from 25 banks regarding the OCB accounts in India and outward remittances effected by them. After scrutiny and investigations, the Enforcement Directorate found that GTB had acted as a custodian for a certain group of OCBs viz. Brentfield Holdings Ltd, Kensington Investments Ltd, Far East Investment Corp. Ltd. etc. and had their PIS accounts. It was the duty of the custodian bank to undertake due diligence to ensure that the OCBs operated within the Exchange Control guidelines. GTB failed in this regard. Besides, on the basis of a number of other violations, the Enforcement Directorate charged the Global Trust Bank and these OCBs under the Foreign Exchange Regulation Act, 1973 in respect of the transactions up to 31/5/2000. These violations are as under:—

(a) Brentfield Holdings Ltd. has been charged for taking their holdings in Aftek Infosys upto 15.2% i.e. 10.02% in excess of the prescribed ceiling of 5% in the individual scrip, thereby violating the provisions of section 29(1)(b) of the Foreign Exchange Regulation Act, 1973. In the case of Global Trust Bank and its officials, to whom the permission was issued by the RBI on behalf of the said Brentfield Holdings Ltd. they have been charged for their failure to comply with the terms and conditions of the RBI as mentioned in Para 10C.21 of the Exchange Control Manual and thereby in terms of section 49 of the Foreign Exchange Regulation Act, 1973, they appear to have contravened the provisions of section 29(1)(b) of the said Act.

- (b) Global Trust Bank Ltd. and its officials have been charged for not questioning the OCBs or advising them to desist from booking purchase orders without having sufficient balance in their accounts or taking declarations to that effect and thereby contravening the provisions of section 6(5) of Foreign Exchange Regulation Act, 1973. Brentfield Holdings Ltd., Wakefield Holding Ltd., European Investments Ltd., Far East Investment Corp. Ltd. and their power of attorney holders have been charged for abetting the said Global Trust Bank in the said contravention.
- (c) European Investments Ltd. and its Power of Attorney holder have been charged for making a purchase of 8,29, 987 shares of SAIL for a total amount of Rs. 1,09,24,241 on credit basis and not taking delivery of the said shares of SAIL and thereby failing to comply with the terms and conditions of the RBI as mentioned in Para 10C.21 of the Exchange Control Manual and thereby contravening section 29(1)(b) of the Foreign Exchange Regulation Act, 1973 read with provisions of section 49 of the said Act.

12.88 For transactions relating to FEMA period, i.e. after 1.6.2000, the Directorate informed the Committee in their written replies that the following charges were found and the Final Report was sent to the Special Director of Enforcement proposing the following charges:—

**(A) Contraventions relating to payments made but shares not received :**

12.89 Regulation 5(3) of the Foreign Exchange Management(Transfer or issue of Security by a person Resident Outside India) Regulations, 2000 which deals with the PIS transactions of an NRI or an OCB specifies the terms and conditions in schedule 3 and 4. Under these it is mandatory that every NRI or OCB investor takes delivery of the shares purchased or gives delivery of shares sold. Investigations have revealed that during the FEMA period, Brentfield Holdings Ltd. (BHL), Wakefield Holdings Ltd. (WHL), Kensington Investments Ltd. (KIL) and European Investments Ltd.(EIL) have made payments in respect of certain transactions but not received shares. The said OCBs and GTB are liable to be charged therefore, under section 13 of FEMA, 1999 for failure to comply with the terms and conditions contained in the schedule 3 under Regulation 5(3) of the said Regulations framed by RBI in terms of section 6(3) and 47 of FEMA, 1999. The complaint under FEMA, 1999 has been filed before the Special Director of Enforcement.

**(B) Contraventions relating to sale of shares but not actually delivered:**

12.90 As OCBs are bound to give delivery whenever they enter into a sale transaction, it was found in the course of investigations conducted by the Enforcement Directorate that during February, 2001, European Investment Ltd. sold 3.5 lakh shares each of HFCL and Global Tele, which were not delivered by them. While explaining this transaction Shri. Noshir. B. Captain, Power of Attorney Holder of EIL, in his statement dated 3.5.2002 stated that the broker had not given delivery of the above said shares purchased during December 2000 and since the market crashed, EIL sold these shares and booked a loss.

12.91 The Directorate informed the Committee that the above said OCB and GTB are liable to be charged under section 13 of FEMA, 1999 for failure to comply with the terms and conditions contained in Schedule 3 under Regulation 5(3) of the said Regulations framed by RBI in terms of Section 6(3) and 47 of FEMA, 1999. The complaint has been filed before the Special Director Enforcement for issuance of show cause notice.

**(C) Contraventions relating to non-payment of money against shares received:**

12.92 The conditions contained in Schedule 3 of the above said regulations also stipulate that payment for the purchase of shares should be made by inward remittance through normal

banking channel or out of the funds held in NRE/FCNR accounts maintained in India if the purchase of the shares is with repatriation benefits. Investigations made revealed that Kensington Investments Ltd. and Wakefield Holdings Ltd. have purchased shares of Zee Telefilms during February, 2001 but did not make any payment towards the said purchases. Hence, according to the Directorate, these OCBs and GTB are liable to be charged under section 13 of FEMA, 1999 for failure to comply with the terms and conditions contained in Schedule 3 of the said Regulations framed by RBI in terms of section 6(3) and 47 of FEMA, 1999. The complaint in this case has also been filed before the Special Director of Enforcement for issuance of show cause notice.

**(D) Contraventions relating to purchase on credit basis:**

12.93 Investigations conducted by the Enforcement Directorate further disclosed that Kensington Investments Ltd. purchased 16,50,000 shares of HFCL for a total sum of Rs. 191 crore on 20th and 21st June, 2000 and received the shares, however the payments were made by Kensington Investments Ltd. only on 13th, 16th and 23rd of Oct. 2000 after a lapse of nearly 100 days. The terms and conditions stipulate that every purchase should be made by inward remittance and delivery taken, the reason/intention of such legislation is to prevent the OCBs from speculating in the market. There is no provision of making the purchase on credit basis by OCBs. The payment having been made so belatedly makes it seem like a purchase on credit basis. Mr. Chandran of Kensington Investments Ltd. in his letter dated 31.7.2001 addressed to GTB explained that they were unable to raise the required fund at that time and hence the payment was deferred. It is therefore, apparent that the said purchase by Kensington Investments Ltd. to the extent of Rs. 191 crore was on credit basis. Hence the GTB and the OCB are liable to be charged under section 13 of FEMA, 1999 for the failure to comply with the terms and conditions contained in Schedule 3. The complaint has been filed before the Special Director for issuance of show cause notice.

**(E) Contraventions relating to ceiling limit:**

12.94 The provisions of schedule 3 further stipulates that the paid up value of the shares of an Indian company purchased by an OCB should not exceed 5% of the paid up value of the shares issued by the company concerned. Investigations however, revealed that in certain instances certain OCBs viz. Kensington Investments Ltd. and Far East Investment Corporation Ltd. (FEICL) breached the 5% ceiling in the scrips of Shonkh Technology, DSQ Bio Tech, Mascon Global and GTB. These OCBs and GTB by breaching the 5% ceiling have hence, made themselves liable to be charged for the said contravention under section 13 of FEMA, 1999. The complaint has been filed before the Special Director for issuance of show cause notice. As regards Brentfield Holdings Ltd. (BHL), it is seen that they have crossed 5% ceiling in Aftek Infosys on 22.5.2002. Hence GTB and BHL by breaching the 5% ceiling and thereby failing to comply with the RBI condition appear to have contravened provisions of section 29(1)(b) of FERA, 1973. The show cause notice under the relevant provisions of FERA, 1973 has been issued by the Special Director of Enforcement.

**(F) Contraventions relating to placement of purchase orders without having sufficient balance to their credit:**

12.95 A statement of several instances where OCBs have placed purchase orders without having sufficient balance to their credit, was furnished by RBI. The plea of the bank that they are not privy to the transactions which are between the OCBs and brokers and they came to know of the transactions only when the contract note is produced was rejected by the Directorate on the basis of the following reasons:—

Investigations disclosed that in most of the cases the contract note is produced within two days of the transactions. Obviously, on perusal of the contract notes, GTB would have come to know that purchase orders are being booked without sufficient balance. There are several such instances, as pointed out by RBI, two or three of which are listed below:—

- (i) Wakefield Holdings Limited (WHL) purchased 25 lakh GTB shares on 3.5.2000 when the balance in the account was only Rs. 61 lakh. The contract was submitted to the bank on 4.5.2000 for a total purchase price of about Rs. 14 crore. On perusal of the contract GTB would have come to know that the balance even on that day was not sufficient, let alone 2nd May which was the date of placing the order.
- (ii) Similarly, in another instance WHL purchased 82,050 shares of Cadilla on 19.5.2000 for Rs. 1.42 crore and a contract submitted to GTB on 20.5.2000. Further it was purchased by HFCL and Hoechst for a total consideration of Rs. 149 crore. At this point of time Cadilla's purchase payment was still due. Even then the officials of GTB did not question Mr. Yashpal Kumar, holder of Power of Attorney for the OCB, as to how funds would be arranged to clear these dues and take delivery.

12.96 It was pointed out that RBI had not stipulated the condition that funds should be available at the time of booking the purchase orders, however, both the authorised dealer i.e. GTB and OCB were aware that the OCB was allowed to transact only on delivery basis and that funds were required to clear such huge bills. Having come to know that the OCBs were regularly in the habit of placing such purchase orders without sufficient balance, the authorised dealer should have exercised due diligence and taken necessary information or declaration from them as provided under section 6(5) of FERA, 1973. The show cause notice under the relevant provisions of FERA, 1973 has been issued in the matter by the Special Director of Enforcement.

### **Investigations on Ketan Parekh Group**

12.97 The investigations against Ketan Parekh Group were started by the Enforcement Directorate on 7.3.2001 on the basis of a complaint received by them. On being asked as to why investigation was not started earlier even when throughout 1999 it was being reported in the press that the market was booming and Ketan Parekh was instrumental in raising the level of sensex possibly with his ill-gotten money, the representative of the Enforcement Directorate informed the Committee that at that point of time they did not have any information with regard to any foreign exchange violations having been committed by his Group of companies.

12.98 In the status Report furnished to the Committee on 25.9.2002, the Directorate informed that Shri Ketan Parekh was operating through two broking firms viz. Triumph Securities Ltd. and Classic Credit Ltd. Other than these, some other companies were controlled by his family members. These companies are Goldfist Computers Ltd., Nakshatra Software Private Ltd, Chitrakut Computers Private Ltd, Luminant Investments Ltd., and Panther Fincap & Management Services Ltd. So far as the allegations of market manipulations are concerned, the same fall within the domain of SEBI. The Enforcement Directorate examined Shri Ketan Parekh from the angle of having committed violations with respect to FERA/FEMA. Summons were issued to him and his statement was recorded. A certain group of OCBs pointed out by SEBI in its reports, which largely dealt with certain scrips known as K-10 scrips were also investigated. Transactions of the broking entities of Ketan Parekh were examined in the context of these OCBs. No prima-facie violations of FERA, 1973 however, were noticed against Ketan Parekh group as per existing laws and regulations. The concerned OCBs were however, issued show cause notices as already pointed out above.

### First Global Stockbroking Private Ltd. (FGSB) and Shri Shanker Sharma

12.99 The main charges against the Group are that it was found that the First Global Stockbroking Pvt. Ltd., had entered into transactions of the sale of 5,92,950 shares of the HFCL with FIs, their sub-accounts during March, 2000 at rates ranging between Rs. 1060.50 to Rs. 1075 when the prevailing prices per share were between Rs. 1937 to Rs. 2211. FIs are allowed to sell, purchase shares, debentures, etc. through the stock exchanges only and no off-market transactions or secondary market deals are allowed. To transact such business, FIs require special permission under section 29(1)(b) of FERA, 1973. Similarly any Indian company, issuing preferential shares to FIs must also take special permission from the RBI under section 19(1)(b) of FERA, 1973. Further, any person resident in India cannot transfer any share, any security or create or transfer any interest in security to or in favour of a person resident outside India without general or special permission from the RBI as laid down under section 19(1)(b) of FERA, 1973. The First Global however, transferred the shares of HFCL to FIs without prior or specific permission from the RBI as required under these sections, and thereby committed an offence under section 56(1)(2) for the contravention of section 19(1)(b) of FERA, 1973 read with section 49(3) and 49(4) of FEMA, 1999.

12.100 As per the latest Status Report furnished to the Committee on 25.9.2002, the Directorate informed that besides the selling of shares of HFCL to FIs and their sub-accounts without the express permission of the RBI in contravention of the provisions of section 19(1)(b) read with sections 64(2), 68(1)&68(2) of FERA 1973, all read with section 49(3)&(4) of FEMA, 1999, Shri Shanker Sharma, Ms Devina Mehra and First Global Stock Broking Pvt. Ltd. also acquired an amount of US\$11, 79,037 outside India through their wholly owned subsidiary, viz, First Global Mauritius Ltd. without the permission of the RBI. The data available in the computer hard discs seized from the premises of FGSB along with other evidence revealed that a sum of US\$ 8,00,000 was acquired by them outside India in lieu of investment made in Buffalo Network, Ltd. Delhi, which was part of the said amount of US \$11,79,037. It was further revealed on investigation that a sum of US \$1,25,00 was transferred to First Global(Mauritius) Ltd. by them through Jamila Traders Dubai. This amount of US \$ 1,25,000 was also found to be part of the amount of US \$ 11,79,037. The following show cause notices have been issued to First Global Stock Broking Pvt. Ltd. Shanker Sharma and Devina Mehra and associates for:—

- (a) Acquiring US\$11,79,037 in violation of section 8(1) and 9(1)(f)(i) of FERA, 1973.
- (b) Sale of 5,92,950 shares of HFCL and further by attempting to sell 2,37,600 shares of HFCL, without the general or specific permission of RBI in contravention of the provisions of section 19(1)(b) of FERA, 1973.
- (c) Failure to comply with the conditions stipulated by RBI regarding holding of 100% equity shares of First Global(UK)Ltd.

12.101 Apart from the show cause notices as mentioned above, following complaints have been filed in the Court of the Chief Metropolitan Magistrate, Mumbai against First Global Stock Broking Pvt. Ltd.

Sl.No.	Complaint No.	Accused	Charges
1	2	3	4
01.	Ce/122/W/2002 dated 11.2.02	M/s First Global Stock Broking P. Ltd. its	U/s 19 (1) (b) of FERA, 1973 read with 68(1)of FERA, 1973 & U/s 19(1)(b) read

1	2	3	4
		Directors Associate Cos. Of M/s First Global Trust Bank and its employees	with 64(2) read with 68(1) and 68(2) of FERA, 1973 for the sale of 592950 shares of HFCL to FIs and their sub-accounts without prior permission of RBI.
02	1353/S/2002 dated 28.5.02	M/s FGSB P. Ltd. and its Directors Shri Shankar Sharma and M/s Devina Mehra	U/s 19(1)(b) read with 64(2) read with 68(1) of FERA 1973 for attempting to sell 237660 shares of HFCL to FIs and their sub-accounts without prior permission of RBI
03	587/S/2002	M/s FGSB Pvt Ltd. and its Directors and M/s First Global (Mauritius) Ltd. and its Directors	U/s 8(1) and 9(1)(f)(i) read with 68(1) and 64(2) of FERA, 1973 for acquisition of US \$ 1179037 abroad and making payments amounting to Rs. 3.49 crores in India against receipt of equivalent amount in foreign exchange abroad.

12.102 Transactions relating to period after 1.6.2000 (FEMA) are under investigation.

#### **Zee Telefilms Ltd.(ZTL)**

12.103 Zee Telefilms Ltd. is a company engaged in the business of procurement and production of entertainment software for broadcasting the same through Satellite and Internet as well as other electronic media. Investigations with respect to this company were started by the Directorate on the basis of a report from SEBI. The Report contained information that Zee Telefilms Ltd. had acquired Zee Multimedia Worldwide Ltd. in September, 1999 and had allotted about 1.61 crore shares to Asia Productions Ltd, International Graphics Holdings (Mauritius) Ltd. News Television (Mauritius) Ltd and News Television (India) Ltd. for acquisition of 50% stake each in Winterheath Company Ltd-British Virginia Islands and Programming Asia Trading Co. Pvt. Ltd. India by way of deferred credit and issue of shares of Zee Telefilms Ltd. Though SEBI had not pointed out any specific violation, with a view to seeing if any violations had been committed by the entity under FERA/FEMA, the Directorate obtained the details of the transactions of FIs/NRIs/OCBs for the year 1999-2000 from the Company and confirmed with depository.

12.104 Further, RBI's enquiry report had referred to some irregularities relating to OCB transactions of Zee through Global Trust Bank. RBI vide its letter dated 09.11.2001 forwarded a copy of Global Trust Bank letter dated 1.10.2001 wherein the GTB had furnished clarifications/rectifications to RBI with regard to its earlier reports in respect of the reporting of transactions of sale and purchase of Zee Telefilms shares by OCBs under PIS. A statement of an official of GTB, was recorded on 6.12.2001, wherein it was stated that the sales/purchase transaction of Zee Telefilms shares handled by their Fort Branch which were not reported to their head office, had not been included in the consolidated figures reported to RBI. That some of the share transactions which were under Foreign Investment Promotion Board (FIPB) and from OCB to OCB which were not required to be reported to RBI were reported erroneously to RBI under PIS.

12.105 As regards the request for cancellation of purchases, they stated that a particular number of shares were reported to RBI separately and in the consolidated bourses on particular

dates. Global Trust Bank, *vide* their letter dated 13.12.2001 forwarded the copies of the documents called for, such as the contract notes, covering letters and names of the clients who sold/purchased shares in respect of entries and also confirmed that at no point of time the 5% holding limit by the individual clients was violated.

12.106 Foreign Exchange transactions of the Promoter and subsidiary companies of the Group were also gone through. At present inquiries relating to transactions of period subsequent to 31.5.2000 are underway. The shareholding pattern of Zee Telefilms Ltd. during the FEMA period, is being examined to verify whether foreign equity was within the limit of 49%. Further investigation is in progress to verify the following:

- (a) Whether Zee Telefilms Ltd. which has substantial foreign equity participation has taken necessary approvals for acquiring a subsidiary namely Asia Today Ltd., which is into broadcasting.
- (b) Whether Zee Telefilms Ltd. has followed RBI/SEBI guidelines while fixing the share prices at which equity shares were issued to shareholders of Zee Multimedia Worldwide Ltd. and Star Group of Companies.

12.107 Further, as per SIA (Secretariat for Industrial Assistance), guidelines no PDI/NRI/OCB investment is permitted in the field of broadcasting. Zee Telefilms Ltd. has substantial FDI/NRI/OCB investment in its equity. M/s ZTL acquired 100% equity in Zee Multimedia Worldwide Ltd. (ZMWL) by way of 1,94,18,800 shares of Rs. 10 face value, after obtaining SIA/FIPB/RBI approvals. Zee Multimedia Worldwide Ltd. is a holding company, which among other things owns 50% equity in Winterheath Company Ltd., the other 50% being owned by Star Group of Companies. Winterheath Company Ltd. in turn is 100% holding company of Asia Today Ltd., Mauritius, which is broadcasting Zee TV, Zee News and Zee Cinema. Thus, by acquisition of Zee Multimedia Worldwide Ltd., Zee Telefilms Ltd. became 50% owner of Asia Today Ltd. (ATL), which is into broadcasting. Subsequently, Zee Telefilms Ltd. acquired the other 50% in Winterheath Company Ltd. by allotting shares in Zee Telefilms Ltd. to Star Group of Companies as well as by making payments to Star Group, after taking approvals from SIA/FIPB/RBI. With this acquisition Zee Telefilms Ltd. became 100% owner of Asia Today Ltd.(ATL), Mauritius, which is in field of broadcasting. The Directorate informed that in view of the above, letter to Ministry of Law is being sent seeking clarification as to:

- (a) Whether Zee Telefilms Ltd. as 100% owner of Asia Today Ltd., Mauritius (through ZMWL & Winterheath Company Ltd.) can be considered as a company engaged in broadcasting?
- (b) As per SIA guidelines no FDI/NRI/OCB investment is permitted in the field of broadcasting (ZTL has substantial FDI/NRI/OCB investment in its equity). In this context can Zee Telefilms Ltd.'s acquisition of subsidiaries abroad, which are engaged in broadcasting be considered as violation of SIA guidelines?

#### **DSQ Software Ltd.**

12.108 The FERA angle in the matter of DSQ Software Ltd. revolves around the allotment of 30,00,000 equity shares of Rs. 10 each to New Vision Investment Ltd., U.K. at a premium of Rs. 970 per share on 20.5.2000. The company had the requisite foreign collaboration approved from the Directorate of Industrial Policy and Promotion *vide* No. FC-32/93/EOB/507/92 dated 19.4.93 as amended from time to time read with letter No. EO 507/92 dated 24.12.99 and 10.3.2000. Though the said approval covers allotment *inter alia* to a foreign company, conditions were laid therein that the overseas investment shall be with the prior approval of RBI and pricing

of shares shall be as per SEBI guidelines. RBI *vide* letter No. EC.CO.FID(II)/5560/10,02.42 (D-28)99-2000, dated 20.5.2000 had given 'in principle approval' for the allotment of 30,00,000 shares to Foreign Institutional Investors (FIIs) subject to certain conditions, *inter alia* that the FIIs should not only be registered with SEBI but also have RBI permission under FERA for making investment in the Indian capital market.

12.109 According to the Directorate, whereas New Vision Investment Ltd. does not appear to be an FII and does not have any RBI permission under section 29 of FERA, in order to tide over the matter, the Company wrote to RBI on 24.5.2000 stating that they presumed that RBI "in principle approval dated 20.5.2000" even covered allotment in favour of a foreign company. RBI then clarified that the in-principle approval dated 20.5.2000 was for issue of shares to FIIs only and as regards issue of shares to foreign companies, the company may approach FID.I. department of RBI for the requisite permission.

12.110 During the course of evidence tendered on 25.2.2002 before the Committee, the Directorate informed that Shri Dinesh Dalmia was not responding to the repeated summons and was trying to evade the same on one pretext or the other. On being asked by the Committee as to what action was taken in the case of First Global when Shri Shanker Sharma was also following the same practice, the representative informed that he was arrested. However the reason why the same course was not adopted in the case of Shri Dalmia was that the Directorate was dealing with him under FEMA and not FERA. Under FEMA for non-appearance, only penalty can be imposed. When the Committee expressed their concern that there could also be FERA violations committed by him and in case the Directorate showed slackness, the FERA would cease to exist as the sunset clause would also expire, the representative informed as under:—

"So far as SEBI is concerned, we have requisitioned the documents from it. But, so far, we have not received the documents."

12.111 On being queried as to why the information was not obtained from SEBI and why the Directorate was not hurrying up, the Director (Enforcement) replied. "We have not got a reply so far.... We will personally contact them." He also informed that the letter was written to SEBI on 28.9.2001. On being asked whether after 11.1.2002, there had been no effort to go to SEBI, the witness conceded, "After 11.1.2002, there has been no effort to go to the SEBI to find out."

12.112 The Committee were later informed by the Directorate that since the details were not forthcoming from the company, a search operation was conducted at the residential and business premises of the company and its Directors on 6.3.2002. It was also informed by the Directorate that it appeared that violations had been committed during FERA period as well. Further, DSQ Software Ltd. and its four Directors including Shri Dalmia were charged with the contravention of various provisions of FERA, 1973 *i.e.* (1) in the matter of acquisition of Sterling Pounds 45,70,000 in May, 2000; (2) in the matter of issue of 30 lakh shares for a total share price of Rs. 294 crore to M/s New Vision Investment Ltd., U.K. on preferential basis on or around 20.5.2000; (3) in the matter of foreign exchange worth Rs. 264.41 crore; and (4) for making false statements.

12.113 The Committee were informed subsequently that as a result of the investigations relating to FERA period, apart from initiating adjudication proceedings, prosecution has also been launched against DSQ Software Ltd. and its Directors for unlawful acquisition of Sterling Pounds 45,70,000/-, for attempt to issue 30,00,000 shares valued at Rs. 294 crore in contravention of FERA to a UK based OCB in the matter of preparations to illegally acquire foreign exchange worth Rs.264.41 crore, and for making false statements. The investigations into other aspects/issues are in progress.

12.114 With regard to the allegation against DSQ Group concerning the swapping of assets with Fortuna Technologies, USA for which DSQ Software Ltd. had reportedly issued 1,40,00,000 equity shares to New Vision Investment Ltd., Mauritius and others, the Directorate informed that the said deal took place after January, 2001 and is thus a FEMA period transaction. As per details submitted to stock exchanges by Shri Dalmia, 1.4 crore shares of DSQ were to be allotted to three Mauritius based OCB's viz. Technology Trust Ltd., Softec Corporation Ltd. and New Vision Investments Ltd. at a price of Rs. 973 crore. Before Enforcement Directorate Shri Dalmiya however stated that the shares were never allotted to the Mauritius based companies but to three Indian companies of the same name under instructions from Shri T.C. Ashok, owner of Fortuna Technologies.

12.115 That the deal appears fraudulent is confirmed from the fact that Shri Dalmiya, MD of DSQ had made false submissions to stock exchange regarding Extraordinary General Meetings (EGMs) and allotment committee meetings that never took place. This is confirmed from record and the statements of other Directors. Further investigations in the matter are underway.

12.116 In the case of DSQ Biotech, partly paid shares were allotted to OCB's and FII's after receiving 10% of the call money. The company has submitted that these partly paid shares were sold, later, to some Indian companies as partly paid shares. These companies are Continental Filaments Ltd., Uniforge Steel Workshop Ltd. and Athena Software Systems Ltd. Further enquiries in the matter have revealed that Athena Software Systems Ltd., a company that paid 90% of the balance amount required to be paid by Mauritius based OCBs, is the company having its earlier name as DSQ Software. Enquiries in the matter have also revealed that the companies viz. M/s Continental Filament and M/s Uniforge Steel Ltd. which had made payments to DSQ listed in connection with the balance 90% payment required to be received from OCB, are not existing at the known address. This transaction took place on 29.3.2001 and is thus covered by FEMA. However, National Securities Depository Ltd (NSDL) records seem to indicate that these shares are in the name of the original allottees as fully paid shares since October 2000 which is also a FEMA period transaction.

12.117 Shri Dinesh Dalmiya of DSQ Software Ltd. he was summoned several times for his appearance on 7.5.2002, 10.5.2002, 15.5.2002, 16.5.2002, 18.6.2002, 4.7.2002, 15.7.2002, 10.7.2002, 14.8.2002 and 19.9.2002. Shri Dinesh Dalmiya has not appeared on any of these dates and is avoiding summons. Investigations in the matter are in progress but due to avoidance of summons by Shri Dinesh Dalmiya and due to his non-cooperative attitude the investigations are getting hampered.

**12.118 The Committee note that the investigations conducted by the Enforcement Directorate with regard to the violations of foreign exchange committed by OCBs/FIIs under the relevant provisions of FERA/FEMA, did not make much headway till the irregularities were pointed out by SEBI in their report and the report of the snap inspection was made available by the RBI. This leaves the Committee with an impression that there is no effective surveillance system existing in the Directorate under which the violations could be detected soon after the crime is committed and an immediate check imposed. The case of DSQ Software is an instant example where even when the shares were sold to a foreign company way back in May, 2000, without the express permission of the RBI, the investigations were started only in August, 2001. In fact the Directorate geared itself up only at the instance of the JPC and ultimately launched prosecution against the Company on 30th May, 2002 i.e. the penultimate day when the sunset clause of FERA, 1973 was to come to an end.**

**12.119 The Committee note that the investigations taken up by the Directorate are confined mostly to such cases where either the complaints are received or where the irregularities get**

pointed out by some organizations. The Committee are however of the considered view that in a highly liberalized and free market economy of today, where e-commerce, mergers and joint ventures are taking place at a pace which had not been witnessed before, it is essential that the Directorate also revamps itself in consonance with the emerging demands by imparting suitable training to the staff not only in corporate laws but also in cyberspace and computerization. Besides, it needs also to strengthen its intelligence/surveillance department so that it becomes a vibrant and effective instrument.

12.120 The Committee find that OCB route has been used by some of the broking entities in manipulating the market in the present scam. Investigations conducted by the Directorate revealed that certain OCBs committed a number of violations under FERA, 1973 as well as FEMA, 1999. It is however, surprising that these OCBs were not regulated by any of the regulators and even the violations committed by them both under FERA/FEMA had gone un-noticed even by the Directorate of Enforcement till these were pointed out by SEBI in their Interim Reports. Some of these irregularities include sale and purchase of shares without actual deliveries, purchase of shares on adjustment basis without fund flows from their accounts to the accounts of the brokers, booking of purchase orders without sufficient balances in their accounts, exceeding 5% ceiling as prescribed for individual OCBs and violations of 10% aggregate ceiling norms, etc. These OCBs include M/s Brentfield Holdings Ltd, M/s Wakefield Holdings Ltd, M/s Kensington Investments Ltd., M/s Far East Investment Corporation Ltd. and M/s European Investments Ltd. The Committee are given to understand that except M/s Brentfield Holdings Ltd. which has been issued show cause notice under FERA 1973, in the case of others, final complaints have already been filed under the relevant provisions of FEMA 1999 before the Special Director of Enforcement for adjudication. Besides, 16 FIs and their sub-accounts have been charged under section 29(1)(b) of FERA, 1973 relating to the purchase of 5, 92,950 shares of HFCL from First Global Stock Broking Pvt. Ltd. without specific approval of RBI. FIs and their sub-accounts have also been charged under section 29(1)(b) read with section 64(2) of FERA, 1973 for attempted purchase of 2,37,600 shares of HFCL from First Global Stock Broking Pvt. Ltd. without specific approval of RBI. The Committee desire that all these cases should be decided expeditiously.

12.121 The Committee note that the investigations against ZEE Telefilms have been inconclusive so far, as the Directorate has not yet found any FERA/FEMA violations by the company. The Committee desire that the investigations should be pursued further with a view to ascertaining if at all any violations were committed.

### 3. CENTRAL BOARD OF DIRECT TAXES

#### A. Action Taken on Security Scam of 1992

12.122 The role of CBDT was mainly confined to the action taken with respect to cases of the security scam of 1992 and investigating those who actively participated in the present scam, with a view to ascertain whether they evaded income tax. The Department on being queried about the status of the cases relating to the Securities Scam of 1992 and the Harshad Mehta case stated that the assessments for all the years in respect of Harshad Mehta Group and the Bhupen Dalal Group have been completed and demands raised on them. The Committee were informed that in total 401 appeals were pending, out of which 252 appeals have been decided as on 31.8.2001 and 149 appeals are still pending. CBDT has further informed that appeals in 78 cases of notified persons were pending as on 31.3.2002.

12.123 On the reasons for pending of appeals, the representative of the Department stated during evidence:—

".....in most of the cases, especially in the case of Harshad Mehta Group, the Special Court had instructed the concerned brokers to prepare their books of accounts, show

them to special auditors who had been appointed by the Special Court and then put it before the Assessing Officers and pursue the appeals. Till then, the Special Court said, that these cases should not be pursued. Hence appeals in most cases are pending. Those people have not prepared their books of accounts and filed their audit reports. Therefore, the whole issue is stuck up there. The Special Court has taken cognizance of this delay on the part of the brokers and initiated contempt proceedings against them. Most of the other appeals have been finalized in the case of Bhupen Dalal Group and the Income Tax Appellate Tribunal has dismissed their appeals. They have not gone to the High Court so far and therefore in their particular group the cases have become final.”

12.124 With regard to the query of the Committee relating to the punishment given to the economic offenders of the previous stock scam, the representative of CBDT stated during oral evidence:—

“In all these cases penalty has been imposed to the extent of Rs. 700 crore. That is why I invited your attention to the earlier demand which was Rs. 11323 crore whereas at the moment the demand shown is Rs. 11957 crore. This is about Rs. 700 crore addition because of the penalty imposed on that group.”

12.125 On outstanding demand, demand confirmed and demand collected, the Department informed in written replies that the total outstanding demand in the 30 cases of the notified persons is Rs. 11,323 crore as on 31.3.2001 out of which Rs. 8192.34 crore relates to the Harshad Mehta Group and Rs. 3130.66 crore relates to the Dalal Group. Out of this, total demand, only Rs. 3429.67 crore is the priority demand as defined by the Hon'ble Supreme Court and out of this Rs. 2382.85 crore relates to the Harshad Mehta Group and Rs. 1046.82 crore relates to the Dalal Group. Apart from this, the demand outstanding at present in the case of Fair Growth Financial Services Ltd., Bangalore is Rs. 165.70 crore out of which Rs. 51.65 crore is priority demand. The demand confirmed by the orders of Commissioner (Appeals) is Rs. 2038 crore plus Rs. 165.70 crore in the case of Fair Growth Financial Services Ltd. The demand confirmed is less than the outstanding demand because many appeals are still pending before Commissioner(Appeals). The DGIT (Inv), Mumbai is being asked to take necessary steps to ensure that most of the appeals are disposed off as soon as possible. The demand collected is Rs. 262.86 crore. Out of this, Rs. 24.23 crore relates to the Dalal Group and the remaining Rs. 238.73 crore relates to the Harshad Mehta Group. Besides, a demand of Rs. 24.55 crore has been collected through Special Court in the case of Fair Growth Financial Services Ltd. All property of notified persons stands attached and the Special Court alone has jurisdiction to deal with the attached assets, including shares seized by the Income Tax Department during searches carried out by it.

### **Special Courts**

12.126 In a written reply by the CBI in this regard, it was informed to the Committee that the first Special Court for trying offences relating to transactions in Securities was set up on 6.6.92 *vide* notification dated 18.8.1992. Subsequently, upon the matter being taken up with the Government and Chief Justice of the Bombay High Court, Hon'ble Justice M.S. Rane was appointed as Additional Special Judge in February, 1998. Ever since then, two judges are presiding over the Special Court. On being queried if all the Special Courts are operational, the Department informed that the Government in April 1998 had taken up the matter for appointment of two more Additional Special Judges and Hon'ble Supreme Court of India had also recommended the same. The Hon'ble Finance Minister had also addressed a letter on 18.8.99 to the Hon'ble Chief Justice of India. Despite all this, till date only two courts are functional.

### Constitution of the Special Cell

12.127 In Para No. 17.99 of the Report of the Joint Parliamentary Committee which had been presented to the Parliament on 21.12.93, the JPC had recommended that CBDT may examine the role of Industrial houses with respect to the scam and the close nexus between prominent Industrial houses, Banks and brokers. In pursuance to the recommendation, the Central Board of Direct Taxes had by letter dated 20.5.1994 addressed to the Director General of Income Tax (Inv), Bombay asked him to constitute a Special Cell immediately and mentioned that the Cell may comprise representatives from CBI, RBI, Department of Company Affairs, SEBI, IT Department etc. The Cell was to be headed by the Director General of Income Tax (Inv). The Chairman, SEBI in his letter dated 31.5.94 wrote that no useful purpose would be served by nominating any officer from SEBI in the proposed Cell.

12.128 The Special Cell constituted in June 1994, to investigate the role of big industrial house in the scam held five meetings on 28.6.94, 12.8.94, 21.11.94, 10.4.95 and 22.5.95. The broad tentative conclusions drawn from the deliberations in the special cell were as follows:—

- (i) There was widespread laxity in financial discipline and failure to follow strictly the prudent guidelines issued by RBI.
- (ii) There was diversion of funds from banking system to individual accounts of brokers.
- (iii) The Bank Receipts were the major device used for transfer of funds from banking system to brokers accounts.
- (iv) Some of the business houses and their employees seem to be involved in insider trading through friends companies/benami transactions.
- (v) There was wide spread misuse of bill discounting facilities and these were used in a number of cases as accomodation bills.
- (vi) There was diversion of funds from corporate sector/banks to stock market.
- (vii) There were transactions involving purchases and sale of securities which were more in the nature of tax avoidance device *viz.* buying of losses and diverting/splitting of income, etc.

12.129 The DGIT (Inv), Mumbai, in a note on 19.5.95 wrote to CBDT that the Cell had limited resources, lacked statutory and administrative support and had no access to information available with different organizations. He, therefore, requested for creation of a Special Task force with legal and administrative support, defining clearly the objective of inquiry, etc.

12.130 In response thereto the Member (Inv), CBDT, in a letter dated 22.6.95 clarified to the DGIT (Inv), Mumbai in the following terms :—

“Each of the organizations which is represented in the Special Cell, already has a mass of information collected by them. It is not the intention that the Department or the Special Cell should embark on new enquiries or exhaustive investigation of all transactions of all Industrial houses in the country. What is required is that the information already available with each of the members of the Special Cell be sifted to see whether any of the Industrial Houses had misused or abused the system, including systematic misuse of funds of banks and financial institutions in collaboration with share brokers...”

12.131 It was further stated that he was separately writing to all Director Generals of Income tax, asking them to give all possible assistance to him and he hoped that he would be able to complete the inquiry and submit the final report before the commencement of the next session of Parliament which would be somewhere in the middle of July, 1995.

## Non-functioning of the Special Cell

12.132 The Special Cell formed to investigate involvement of big industrial houses in the securities scam, and to expose the nexus between brokers, promoters and bankers, however, stopped functioning after May, 1995. While admitting that the Special Cell was dysfunctional in the last six years, the representative of CBDT stated during oral evidence that Income Tax Department had a limited role to play in the running or functioning of the Special Cell and that the faults pointed out were outside the Income Tax Deptt.

12.133 On the question of the action taken in the interregnum by CBDT in respect of the functioning of the Special Cell and various agencies in it, the Department stated during evidence that they have written a few letter(s) in this five or six year interregnum to find out the further progress made. Each of the agencies, somehow or the other, could not get together and give a specific finding as far as the nexus was concerned. Otherwise, each of the agencies, like the Company Law Board, have imposed fines. The Department further stated that they have the details on that and they have raised demands where-so-ever the tax angle was concerned. The Department further added that all other agencies including CBI have taken action separately. The Cell did not submit a clear-cut finding on the nexus part in spite of the fact that the Board during these five or six years have been writing to the DGIT, Mumbai.

12.134 After the Committee expressed concern for inaction, they were informed that the DGIT (Inv) was asked to set a definite time frame for the completion of its work on the issue of nexus. The records of CBDT did not show that the Special Cell had passed on any information to SEBI. The DGIT (Inv), Mumbai would be asked to consider whether the information available with the Cell, called for any action by SEBI. If so, the relevant information would be passed on to SEBI and the SEBI would again be requested to associate itself with the meetings of the Special Cell.

12.135 The Committee noted that the Special Cell had started meeting w.e.f. 31.7.2001 onwards at the instance of the present JPC. Subsequently, in September, 2002 the Department of Revenue informed the Committee that the Special Cell has finalised its report. The conclusions and findings about nexus which have *prima facie* emerged are as follows:—

- (i) Nexus between Brokers and Banks/Financial Institutions—Nexus was prominently visible more with foreign banks through various Instruments, Modes and Methods for funds deployment and returns thereon.
- (ii) Nexus between Industrial/Business Houses and the Banks—Nexus was mainly through the Portfolio Management Scheme, violation of RBI guidelines e.g.: Assured Returns etc.
- (iii) Direct nexus of collusive nature between the Business Houses and the Brokers:—No such direct nexus of collusive nature is found to be existing at the relevant point of time either by the Income Tax Department or the RBI or the CBI or the Department of Company Affairs. No Cases were found where funds were placed by Industrial Houses directly with the Brokers enabling them to play in the Share/Securities Market with a view to create artificial booms or depressions so as to book abnormal profits to the detriment of the common investors. No doubt, the brokers indeed had many a times easy access to the funds of some of the Banks.

## **B. Present Stock Market Scam (2001)**

12.136 The results of the investigations carried out by the Department concerning 2001 Stock Market Scam so far have *prima facie* revealed some common points in respect of the

stock-brokers searched as is evident from the written reply (via CBDT letter dated 9/7/2001) submitted by the Department, which states:

- (i) The brokers were in possession of unexplained cash, jewellery, etc
- (ii) A broker was diverting the trade and consequent profit to other accounts.
- (iii) There were instances where the clients ID forms are either incomplete or unavailable revealing these accounts to be suspect.
- (iv) Manipulation in accounts to create artificial losses.
- (v) Instances where the name of the institutional trade, profit or loss was passed on to the associate companies.
- (vi) Diversion of profits by the brokers to loss making companies.
- (vii) Some brokers entered into out-of-Bolt transactions which were not reported to the stock exchange to avoid margin money and to create paper transactions to influence the accounting results.
- (viii) It has been noted that the main broker utilizes the services of multiple brokers at BSE, NSE, CSE and other exchanges for their trade. It has been noticed at Calcutta that the brokers have not been using the clients ID while placing the orders for shares in the Exchanges in a regular manner.
- (ix) It has been found that in case of Sub-brokers, no sale/purchase confirmation notes have been issued and in the case of clients, there is considerable delay in transfer of shares to the accounts of the clients. The Agreement forms are also not available in some of the cases.
- (x) In one case, it was found that the paper transactions of different kinds were undergone just to create short term capital loss on paper, whereby the same could be set off against real profits.
- (xi) In one case, a company belonging to a broker falsely claimed heavy bad debts so as to reduce its tax liability.
- (xii) In one case, it was found that a broker was indulging in off-market transactions *i.e.* Non-delivery based transactions outside the Stock Exchange which have been squared up without effecting the delivery of shares. There have been no contract notes issued by the broker.

### **Involvement of Ketan Parekh Group**

12.137 The Income Tax Department in a written reply had submitted that it surveyed Ketan Parekh Group on 11.1.2000. During the course of the survey, Ketan Parekh offered additional income for tax amounting to Rs. 92.265 crores in the hands of various concerns of his group.

12.138 Search and Seizure action under Section 132 of the Income Tax Act was conducted on this Group on 23.3.2001. 13 cases of this Group have been centralised after this action with Deputy Commissioner of Income Tax, Central Circle. The Department informed that for making block assessments, detailed questionnaire have also been issued in cases of this Group. Besides, during search proceedings, past search inquiries and during block assessment proceedings, evidence indicating *prima-facie* huge unaccounted income earned by the assessee during the block period has been collected. These evidences reasonably indicate that substantial demand of tax is likely to be created on completion of the block assessment proceedings. In view of the

facts and circumstances of the case, it is reasonable to believe that the assessee may transfer assets belonging to him or create encumbrances on them to avoid collection of tax through means of attachment of these assets after completion of the assessment, which may take time due to the process of law. Accordingly, it was considered imperative to make provisional attachment of properties for the purpose of protecting the revenue. Therefore, provisional attachment u/s 281 B of the Act has been made in the case of this Group.

### **Involvement of Nirmal Bang Group**

12.139 The Department has prepared appraisal reports on the basis of its initial findings on the Nirmal Bang group. The report has been submitted to the concerned assessing officers. As per the reply submitted by the Department, the initial findings have shown that the Nirmal Bang group issued shares at premium to subscribers. The assessee, i.e. the Nirmal Bang group did not furnish any details in this regard. However, in the course of survey under the Income Tax Act at least three companies were identified who purchased shares on premium from Nirmal Bang Securities Pvt. Ltd, Bang Equity Broking Pvt. Ltd and Bama Securities Ltd. The three companies were : Tricon Fin Ltd,; Gujarat Fiscon Ltd.; and Welplace Portfolio and Financial Consultants Ltd. Further, the shares were bought back by the Nirmal Bang Group Companies from the subscribers of shares at premium. According to CBDT, the logic behind entering into such transactions by the Nirmal Bang group appears to bring unaccounted money available with it in the form of premium so as to avoid tax on the same.

12.140 Asked if the above procedure was adopted to evade tax by various companies, the Department in their reply stated :

“These are collusive transaction(s) involving understanding between two people on what the arrangements would be, how the money would be given back and whether it would be given by way of cash or some other entry made. In the case of Nirmal Bang, the amount was Rs. 4.71 crore..... They were also involved in dividend stripping through mutual funds. This is a little complicated exercise that some companies enter into. Though there is no tax on dividends, in the case of mutual funds, what they do is that the pricing is done with reference to the adjusted value, that is, at the value after deducting the dividend already declared. So, they show the transaction a day later so that they can book the losses on that. Here, no actual delivery of units are effected; it is only a paper transaction. In the case of Nirmal Bang, the amount was Rs. 61 crore; and another small amount of Rs.70 lakh in the case of Shri R.S. Damani.”

12.141 As per the replies furnished, the companies namely the Bang Securities Pvt. Ltd. of the Nirmal Bang group indulged in out-of-Bolt transactions which were not recorded in the stock exchanges. These transactions appear in the ledger account titled “cross broker account”. In this account bills of sale and purchases have been raised resulting into nil payable or receivable.

12.142 The Bang Securities (P) Ltd. earned ALBM charges (Badla charges). The ALBM charges earned, as per Shri Nirmal Bang, were Rs. 11,92,624 which get reflected in the books of Accounts. The CBDT further replied that the quantum of charges earned will, however, be verified by the Assessing Officer

12.143 As for the cases relating to the delay in transfer of shares to clients' accounts it is in violation of SEBI norms. However, according to CBDT, it does not *prima facie* lead to any conclusion about tax evasion. Since the investigations are still incomplete and to be completed by the Assessing Officer, the exact logic behind delay in transfers is not known. As per CBDT, a total of 13 clients have so far been identified in whose names the shares were not transferred

from the pool account of the broker i.e. Nirmal Bang Group. Shares of 9 companies/institutions were transacted by these clients. As per CBDT, the details of other such instances will be known only after SEBI completes its investigations in this connection.

### **Involvement of First Global Stock Broking (P) Ltd.**

12.144 According to CBDT, during their investigations, it was found that First Global Stock Broking Pvt. Ltd. had got allotted 10,68,275 shares of HFCL at Rs. 1050/- per share in private placements to various concerns connected and controlled by Mr. Shankar Sharma (connected to First Global Group), which subsequently sold to First Global Stock Broking (P) Ltd. at Rs. 1060/- per share. Out of these shares 1,42,525 shares were sold to M/s First Global Finance Ltd at Rs. 1060/- on 10.3.2000 which in turn were sold on 1/4, 4/4 and 11.4.2000 in the Stock Exchange at Rs. 2,029/-, Rs. 1,914/- and Rs. 1,349/- respectively thereby earning profit of Rs. 12,34,04,659/- The shares purchased by other concerns were sold on 3.3.2000 at Rs. 1050/- to M/s First Global Stock Broking Pvt. Ltd. which in turn sold to FII's at Rs. 1060/-. The market price of these shares of HFCL on 3.3.2001 was Rs. 2100/- to Rs. 2211/-, whereas the shares were sold to FII's by M/s First Global Stock Broking Pvt. Ltd @ Rs. 1060/- per share on 4.3.2000. Thus they were sold to FII's at 50% of the prevalent market price.

12.145 The CBDT also submitted that the payment for purchase of shares on private placement by various concerns who purchased these shares from HFCL was made out of funds borrowed (subscription amount) against Non-convertible Debenture from Global Trust Bank, Nariman Point Branch, Mumbai in the name of eight concerns owned or connected to Mr. Shankar Sharma. The Department has concluded that the shares were sold to associate concerns of Mr. Shankar Sharma at a price much lower than the prevailing market rate on the date of allotment, mainly because the fund was arranged by Shankar Sharma.

12.146 The department further stated that list of private placement of 70 lacs equity shares has been checked and no irregularity has been committed in allotting these shares by HFCL from income tax standpoint.

12.147 As for ascertaining the profit and loss of the company, the Department has requested RBI to furnish the copies of the accounts of the company. RBI has replied that M/s First Global Stock Broking (P) Ltd is required to submit Annual Performance Report in respect of overseas subsidiaries within 30 days from the expiry of the statutory period for the finalisation of the audited accounts as applicable in the host country. The Annual performance report of the subsidiaries are yet to be received and First Global Stock Broking (P) Ltd. has been reminded in the matter. However copies of financial statements for the year ended 31.3.2000 and 31.3.1999 of First Global (Mauritius) Ltd. have been collected from Mauritius Tax Authorities and a notice has been issued on 19.3.2002 to this company for the returns of income for assessment year 2001-2002.

### **Indo-Mauritius Agreement on Avoidance of Double Taxation**

#### **Background**

12.148 A convention for the avoidance of double taxation and prevention of fiscal evasion with respect to taxes of income and capital gains was entered into between the Government of India and the Government of Mauritius and was notified on 6/12/1983. In respect of India, the convention applies from the assessment year 1983-84 and onwards.

12.149 During evidence the representative of the Ministry of External Affairs stated that:

“India and Mauritius signed the Avoidance of Double Taxation Agreement in August, 1982 to facilitate foreign investors using the Mauritian off-shore sector for channelising investments into India. The agreement was ratified in 1985. It is the first Double Taxation

Avoidance Agreement signed by Mauritius with any foreign country. Later, it signed similar treaties with Pakistan, China, Germany, France, UK, Sweden, Malaysia, Singapore, Luxembourg, South Africa and several other African countries.”

12.150 The convention applies to persons who are residents of one or both of the contracting States. As per Article 2 of the convention the taxes to which this convention applies in the case of India, are the income tax including any surcharge thereon imposed under the Income-tax Act, 1961 (43 of 1961) and the surtax imposed under the companies (profits) Surtax Act, 1964 (7 of 1964). In the case of Mauritius, the convention applies to ‘Income Tax’ applicable in that connection. The Article further stipulates that the convention also applies to any identical or substantially similar taxes which are imposed by either contracting State after the date of signature of the present Convention in addition to, or in place of, the existing taxes referred above. Further, the competent authorities of the contracting States are required to notify to each other any significant changes which are made in their respective taxation laws.

### **Capital Gains Tax**

12.151 Article 13 of the convention deals with taxation of capital gains and it has five paragraphs. The first paragraph of the Article gives the right of taxation of capital gains on the alienation of immovable property to the country in which the property is situated.

12.152 According to the second paragraph the gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in that other State.

12.153 The third paragraph deals with gains from the alienation of ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

12.154 The fourth paragraph deals with gains derived by a resident of a contracting State from the alienation of any property other than those mentioned in the first 3 paragraphs of the Article and gives the right of taxation of Capital Gains only to that State of which the person deriving the capital gains is a resident.

12.155 The fifth paragraph describes alienation as sale, exchange, transfer or relinquishment of the property or the extinguishment of any rights in it or its compulsory acquisition under any law in force in India or in Mauritius.

12.156 With respect to paragraph 4 of the Article, a clarification was issued by Department of Revenue through circular No. 682 dated 30.3.1994 whereby it was stated that the Capital Gains derived by a resident of Mauritius by alienation of shares of companies shall be taxable only in Mauritius according to Mauritius tax law. Therefore, any resident of Mauritius deriving income from alienation of shares of Indian companies will be liable to Capital Gains tax only in Mauritius as per Mauritius tax law and will not have any Capital Gains tax liability in India.

### **Enactment of MOBAA**

12.157 In 1992, there were two significant developments in Mauritius and India. One was the enactment of MOBAA (Mauritius Offshore Business Activities Act) by Mauritius and the other was

the opening up of Indian economy inviting Foreign Institutional Investors (FIIs) to invest in the Indian Capital Market. The Government of Mauritius in exercise of its sovereign powers enacted MOBAA with the object to provide for the establishment and management of the Mauritius Offshore Business Activities Authority, to regulate offshore business activities from within Mauritius, and for the issue of offshore certificates, and to provide for other ancillary or incidental matters.

12.158 During evidence, the representative of the Ministry of External Affairs briefly dwelt upon the background of MOBAA as under:

“In 1992, Mauritius passed the Offshore Business Activities Act under which offshore investors would be considered as residents of Mauritius. Under article 13 of the Double Taxation Avoidance Agreement, capital gains from moveable property shall be taxed only in the State where the entity is resident and in article 4, the term residence was defined as any person who under the laws of that State is liable to taxation therein by reason of his domicile, residence, case of management or any other criterion of similar nature. In 1992, Mauritius passed the Offshore Business Activities Act and after that the residence clause acquired greater meaning since the nature of residence changed in Mauritius. It is also pertinent to note that Mauritius had no capital gains tax imposed under its law.”

12.159 On the question of consultations or interactions, if any, which took place between the Indian High Commission and Mauritius Authorities from 1983 to 1992 and before passing of MOBAA and whether the High Commissioner informed the Indian Government about the contents of such a legislation coming up which was going against Indian economic interests, the Department of revenue submitted that MOBAA is a domestic legislation of Mauritius and that there were no consultations between High Commission of India at Mauritius and the Government of Mauritius during the period 1983-1992 before the said Act was adopted by the Mauritian Parliament.

**Foreign Exchange Inflows**

12.160 As per the department, the RBI has reported year-wise FDI inflow from Mauritius from 1993 onwards as under :

Sl.No.	Year	In Million Rupees
1.	1993	37.50
2.	1994	871.03
3.	1995	15200.52
4.	1996	23283.71
5.	1997	37679.22
6.	1998	30269.85
7.	1999	20255.68
8.	2000	30933.21
9.	2001 (upto (30.9.2001)	61672.80

12.161 As regards year-wise FIIs inflows into India from Mauritius, RBI has informed that this information is not compiled country-wise.

### **Indo-Mauritius interaction on DTAC and other developments**

12.162 The Government of Mauritius enacted MOBAA in 1992. In August, 1993, CCIT, Mumbai brought it to the notice of the CBDT that some asset management companies were using DTAC with Mauritius for preferential treatment. The Chief Commissioner had brought to the notice of CBDT that certain funds had come in through a Cayman Island Registered Company which was a resident of Mauritius. According to the Chief Commissioner, the profit generated on the sale and purchase of shares in India were obtained by the beneficiary located outside Mauritius. The question raised was whether the Treaty benefits should be allowed or not. The CBDT replied that since the gains were not derived by a resident of Mauritius but were being passed on to residents of some other countries through a Mauritius Company, the capital gains would be taxable in India in accordance with the relevant provisions of the Income-tax Act. CBDT approached, in September, 1993, the Indian High Commissioner at Mauritius to take up the matter with Mauritian authorities to ensure that the benefit of our bilateral tax treaty is not allowed to be mis-used by entering into a Protocol by suitably amending the provisions of Article 13 (Capital Gains) of the Tax Agreement.

12.163 The Mauritian authorities, in response to CBDT's letter through the Indian High Commissioner communicated in October, 1993 that all capital funds domiciled in Mauritius for investing in Indian stock market were in the nature of long term funds, that though the beneficiary of such fund may be residing in third country, these funds invest money in Indian stock market in accordance with SEBI norms and regulations and that the Finance Minister of India has himself encouraged such funds as a channel for promoting capital flow into India in a meeting he had with the Finance Minister of Mauritius in Washington. The Mauritian Finance Ministry was willing to have regular contact point with Indian side on exchange of information to allay apprehension about possible misuse of tax treaty by unscrupulous elements. It was also pointed out by Mauritian authorities that the DTAC between the two countries has played a positive role in covering the higher cost of investing in what is currently assessed as high risk security and being decisive in making possible public offerings in USA and Europe of funds investing in India. The absence of such a facility as afforded by Indo-Mauritian DTAC would probably have made the cost of raising such investment capital prohibitive.

12.164 In a meeting on the subject between the Prime Ministers of the two countries, on 23.11.93 at Nagpur it was pointed out that the international funds domiciled in Mauritius targeted India for investment are in the nature of long term schemes and that they were not designed for short term gains.

12.165 A meeting was taken by Principal Secretary to Prime Minister on 25.1.1994 wherein it was desired that our approach on this subject in the Joint Commission should be to make it clear to the Mauritian side that we know that this provision was being misused, and the Mauritian side should be encouraged to try to regulate this problem themselves as their response to our proposed Protocol. It was also decided that India may not take any unilateral precipitate action.

### **CBDT circular of 1994 and setting up of the Joint Working Group (JWG)**

12.166 Subsequent to this, CBDT issued a clarificatory circular No. 682 of 30.3.1994 to the effect that any resident of Mauritius deriving income from alienation of shares of Indian companies would be liable to capital gains tax only in Mauritius and will not have any capital gains tax liability in India.

12.167 On the issue of the necessity of issuing of the circular, the representative of CBDT submitted during evidence as under :

“The Circular of 1994 was issued subsequent to the issue of capital gains having been raised in the newspapers pursuant to a clarification issued by CBDT to the Chief Commissioner of Income Tax, Mumbai. The Chief Commissioner had brought to the notice of the CBDT that certain funds had come in through a Cayman Island registered company, which was resident of Mauritius. According to the Chief Commissioner, the beneficiary located outside Mauritius was obtaining the profits generated on sale and purchase of shares in India.”

12.168 Subsequently, in a post evidence reply furnished by the Department, it was stated that no assessment order denying the treaty benefits under Indo-Mauritius Double Taxation Avoidance Convention to any Mauritius based company was passed either before the issuance of Circular No.682 dated 30.3.1994 or thereafter till March, 2000.

12.169 CBDT further submitted in a post-evidence reply that after the circular was issued, it was felt that any amendment or review of the Double Taxation Avoidance Convention (DTAC) with Mauritius will invite similar reviews of DTAA's with other countries with whom we have similar Articles on taxation of capital gains. It was felt that at that juncture that withdrawing these benefits from various Treaties will be a long drawn process unless other countries agree which they were unlikely to do.

12.170 However, the matter regarding renegotiating our Treaty with Mauritius was taken up through the Ministry of External Affairs. The High Commissioner of India in Mauritius requested for a review of Indian proposal as the entire Mauritius financial offshore sector was based on India related business and any move to change the Treaty provisions would result in diversification of these funds to other markets. Any decision to close the Mauritius window would have an adverse impact on perceptions of potential investors worldwide and it could be seen as a move to restrict capital inflows into India.

12.171 During the visit of Mauritius Finance Minister in September, 1994 and his meeting with the Indian F.M., an impression was left that India was not contemplating any change in the current provisions. The Indian High Commissioner suggested that Mauritian offer for regular confidential exchange of information be used to seek some modification in the provisions without harming a significant and dynamic sector of the Mauritian economy and ensuring that investor perception of India as attractive outlet for capital funds does not suffer in the process. A decision was taken in March, 1995 at the level of the Finance Minister not to precipitate matters at the stage and to try to pursue for a dialogue with Mauritian authorities.

12.172 In April, 1995, the matter relating to renegotiating the treaty was taken up again with Mauritius authorities. On the events preceding the setting up of Joint working group, the representative of Ministry of External Affairs stated during evidence as under:

“As per our records, around 1993, the Department of Revenue raised the issue of possible loss of revenue on account of offshore companies using the Mauritius route to invest into India, claiming residence in Mauritius and not paying capital gains tax in India. Efforts to renegotiate the Treaty were resisted by the Government of Mauritius and finally, a working group was constituted between India and Mauritius to hold talks to review the existing Convention. A Mauritian delegation led by their Foreign Secretary had discussed this issue with the Chairman, CBDT in August, 1995. The matter was also taken up by the Finance Minister of Mauritius with the Finance Minister of India on 31.8.95. The Indian side

emphasized the need for the review of the Treaty in view of the possible misuse of the provisions relating to the capital gains tax. At the conclusion of these negotiations in August, 1995, it was decided to set up a joint working group. The first meeting of the working group took place in December, 1996.”

12.173 The representatives of the Ministry of External Affairs further deposed during evidence as follows :

A meeting was held by the Prime Minister’s Office (PMO) on this subject which was taken by the Principal Secretary of the PMO on 16.12.96. Secretary (Revenue) and Secretary (West) from the Ministry of the External Affairs were present at this meeting. The Ministry of External Affairs gave the following views in this meeting:

1. There were 17 agreements for avoidance of double taxation with various countries which provided for the capital gains (tax) provisions and Mauritius should not be singled out for action because we had good political relations with Mauritius.
2. The Prime Minister of Mauritius had earlier been assured that action taken would be non-discriminatory and non-disruptive to the Mauritian economy.
3. The Principal Secretary to the Prime Minister had indicated that no discouragement to capital inflows coming to India should be undertaken.

12.174 The Secretary (Revenue) had agreed with that and said that he would bring a Cabinet Note seeking appropriate amendments in all the Double Taxation Avoidance Agreements to prevent avoidance of capital gains tax in India. Following the policy decision, re-negotiations would be opened up with several countries and Mauritius would be among the first three for the re-negotiations of the agreement.

12.175 On the issue of reinvestment in India of funds from India based companies in Mauritius which were exploiting the treaty to their advantage, the representative of Ministry of External Affairs deposed before the Committee as under:

“.....when the first meeting of the joint working group took place in December, 1996, it was agreed that the Mauritius Offshore Business Activity Authority will not register any India-based company which applies for registration and bring funds from India for investment into India and where such registration had already been granted, it would be revoked since India-based companies were not eligible for the benefits of such a facility. It was agreed that this understanding would be placed in a note verbal to be issued by the High Commission of India to the Ministry of Foreign Affairs of Mauritius with a copy to the Ministry of Finance of Mauritius. This was done in consultation with the Ministry of Finance in India. A draft note verbal was prepared by the High Commissioner of India and they sought the clearance of the Ministry of Finance before issuing it.”

12.176 The witness further added as under:

“However this note verbal could not be issued because the Ministry of Finance consulted other Departments including the Ministry of Law. Whereas all other Ministries cleared but the Ministry of Law did not give their clearance. On 14.7.1998, the Ministry of Finance informed our High Commissioner that as per the Ministry of Law, the revocation of certification proposed in the exchange of notes would be subjected to judicial scrutiny in the Mauritius courts and therefore felt that the proposed action in the exchange of notes may not serve our purpose. The High Commission, therefore was asked to take up

this view with the Mauritian side. The High Commission informed the Ministry of External Affairs and the Ministry of Finance on 11.9.1998 that the matter had been taken up with the Ministry of Finance, Government of Mauritius and they have been reminded. The Ministry of External Affairs informed the Ministry of Finance that the matter could also be taken up with the Finance Minister of Mauritius when he visited India on the 23.9.1998 and 24.9.1998 and met the Indian Finance Minister. On 24.9.1998, the High Commissioner of India informed the Ministry of Finance and the Ministry of External Affairs of the response received from the Mauritian side to the concerns of the Law Ministry which *inter-alia* said that the exercise of statutory powers could be subjected to judicial review but is available only when the charge is of arbitrary use. Such availability of judicial review was a part of the legal process and not specific to Mauritius. The Mauritian side felt that the availability of judicial review would not deter it from taking action as committed."

12.177 On the question of record of exchange of notes with Government of Mauritius after the discussions, the witness replied that there is no record on files with reference to this subject.

12.178 The Department in a post-evidence note further clarified the matter that in the first meeting of the working group between India and Mauritian authorities held in December, 1996, initially the Mauritian authorities were not prepared to discuss or agree to any change in Indo-Mauritian Treaty on the ground that its offshore financial sector would be adversely affected if any changes were made in the Treaty. However, a view was taken that India based companies availing of the benefits as investors in India *via* Mauritius could be denied registration and even if already registered, the registration could be revoked. Ministry of Law in India initially did not agree to this proposition on the ground that de-registration, once challenged in the Court, may not succeed but later on agreed to the view after the Mauritian authorities informed the views of their legal officers that the arrangement was workable. Subsequently, this move was not supported by the Ministry of Finance on the ground that RBI had approved the proposed investment of Indian Companies in Mauritius under the prevailing policies of Government and it would be unfair to deny the benefits of the Treaty to India based companies only while other entities continue to enjoy the benefits.

12.179 A delegation led by the Finance Minister of Mauritius called on the Finance Minister of India on 24.9.1998 wherein it was clarified by the Mauritian F.M. that as per the Mauritius law, there should not be any difficulty in de-registering such Indian companies that may be registering in Mauritius to avoid domestic tax incidence. Another meeting was held on 13.10.1998 between Finance Minister of India and the Prime Minister of Mauritius wherein the issue of DTAC between India and Mauritius was discussed.

#### **Loss of revenue and the issue of denial of treaty benefits**

12.180 Again, in March, 2000 the treaty benefits under Indo-Mauritius DTAC were denied to a few FIs by Assessing Officers in Mumbai on the ground that these companies though incorporated in Mauritius under MOBAA were actually residents of other countries like Luxembourg, UK and USA. The ground taken by the assessing officer was that the recipients of income arising in India in these cases were investors residing in a country other than Mauritius and these offshore companies have been established in Mauritius only to take advantage of its tax efficient treaty with India and, therefore, they are not *bonafide* residents of Mauritius. The Assessing Officer had held that since FIs were residents of neither Mauritius nor India, provisions of Indo-Mauritius DTAC were not applicable.

12.181 Referring to these cases, the representative of CBDT submitted during evidence that these cases were investigated in March, 2000 and orders were passed on different dates from 27.3.2000 to 30.3.2000.

12.182 The CBDT elaborating further on the issue of show-cause notices in those cases, stated:

“In fact, the background in those cases is that notices had already been issued. When the notices were issued these were brought to the notice of the tax authorities in Mauritius and I think that made the Finance Minister of Mauritius write that letter. But the show cause notices issued by tax authorities were followed up and they finally ended up in assessments being made in those 24 cases. So, they were in the nature of raising tax demand in those cases, not giving them the treaty benefit of Indo-Mauritius DTAC...”

12.183 The denial of Treaty benefits under Indo-Mauritius DTAC to a few FIs in March, 2000 assumed diplomatic overtones as the Mauritian Finance Minister in a letter dated 27.3.2000 to Indian Finance Minister took up the issue stating that the Mauritian offshore centre which hosts some of the largest and reputable financial institutions and fund management companies, has been instrumental in creating FDI and portfolio investment into India and has thus facilitated the Indian Economic Reform and Development Process. Companies incorporated under our offshore regime are residents in Mauritius for tax purposes. Such companies, when investing in India, have always been subject to tax in accordance with the provisions of the Double Taxation Agreement between Mauritius and India.

12.184 The Indian High Commissioner in Mauritius while forwarding his letter dated 28.3.2000 conveyed the following at the instance of the Finance Minister of Mauritius:

- (a) the Indo-Mauritian Double Taxation Avoidance Treaty has been working well and both countries have benefited from it;
- (b) any abrupt decision to suspend or terminate implementation of its provisions would have serious implications for Mauritius and would be contrary to the spirit of our very special relations;
- (c) in case there are any Indian concerns of recent origin, these can be addressed through discussions between officials from both sides;
- (d) he earnestly hopes that our Tax authorities in Mumbai will not adopt and implement new regulations before the matter is discussed by officials from both sides.

#### **CBDT Circular of 13.4.2000**

12.185 Subsequent to the 27.3.2000 letter of Minister of Finance of Mauritius, the CBDT issued a circular on 13.4.2000 according to which it was clarified that wherever certificate of residence is issued by the Mauritian authorities, such certificate will constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying DTAC accordingly. Further, the status of residence mentioned would also apply in respect of income from capital gains on sale of shares. Accordingly, FIs etc., which are resident in Mauritius would not be taxable in India on income from capital gains arising in India on sale of shares as per paragraph 4 of Article 13. The aforesaid clarification shall apply to all proceedings which are pending at various levels.

12.186 On being asked to confirm whether the income tax notices issued earlier were withdrawn after Finance Minister of Mauritius took up the issue with Finance Minister of India and that he is ready to address Indian concerns of recent origin through discussions between officials from both sides, the representatives of CBDT responded as under :

“The notices were not withdrawn. The orders of assessment were passed in those respective cases where the notices had been issued. Later on, when this matter was brought to the

notice of the CBDT, the CBDT issued a circular on 13th April (2000) clarifying the provisions of the Double Taxation Avoidance Agreement and what really amounted to residence in terms of DTAC provisions."

12.187 On being further asked about the steps taken by the Government of India after 28.3.2000 through diplomatic channels to convey the Indian concerns, if any to the Government of Mauritius, the representative of Ministry of External Affairs responded:

"There is only a reference that the Finance Minister of India responded on 13.5.2000 to the Finance Minister of Mauritius and indicated that the tax authorities had issued a clarification to accept the Certificate of Residence issued by Mauritius authorities and apply the provisions of the Treaty accordingly. After that, we do not have any other record."

12.188 Elaborating further on the issue of circular of April, 2000, the representative of CBDT stated during evidence:

"The point at issue was that under the DTAC provisions, there is a clause for the taxability of capital gains and another clause for taxability of dividends. As per DTAC, capital gains are taxed in the country of residence, that means if the company is resident of Mauritius, it would get taxed there. But dividends can be taxed in both countries depending upon the beneficial ownership. Now this clause of beneficial ownership applies to the dividends and not to the capital gains. But the assessing authorities in Mumbai took this argument further and took it to capital gains also relying upon some decision of Authority for Advance Rulings in that case. Later on, that very authority had given, in a number of cases, decisions admitting the question where it was earlier denied. The CBDT examined in detail the provision of DTAC. It specified such cases where capital gain liability would arise and where dividend tax liability would arise and after taking into account all those considerations, they came out with that circular stating what should be the correct view otherwise it would have led to litigation, uncertainty in the foreign market and it would have affected the situation."

12.189 The Secretary, Department of Revenue further stated that this Circular of April, 2000 in a way reiterated the 1994 Circular. Clarifications had been issued on provisions of DTAA. Actually after MOBAA came into effect, this position was taken by the Board in 1994. So, subsequently, on this particular issue, to his knowledge, there have not been any discussions on this issue.

12.190 On being further queried whether prior to the issuance of the show-cause notices, there were no concerns of Government of India, the Secretary, Revenue replied as under:

".....on the issue of the agreement, there has been discussion by the Working Group and all such things. This has been a continuing process."

12.191 Subsequently the witness mentioned that the concerns were mainly related to the Indian entities getting set up in Mauritius and routing. That was the concern that was being examined all through by the Working Group. The Department agreed that the concern in this regard was that this was harming the Indian economy because India was not getting the tax that was due to it despite the CBDT circular of 1994 and MOBAA. Therefore the Department of Revenue wanted that this should come within the Indian Tax net and that these were the concerns that were communicated to the Mauritian Government .

12.192 The Department further added that 1994 circular clarified the interpretation of the existing DTAC. At the same time the discussions were continuing whether DTAC in its extant form should continue or not.

12.193 The Secretary, Revenue subsequently stated during evidence that the March 2000 assessment orders—the 24 orders—were an aberration and CBDT had in the circular of 13.4.2000 clarified how capital gains be considered or taxed.

#### **Resident clause of the treaty**

12.194 The 13.4.2000 circular mentions that the “provisions of the Indo-Mauritius DTAC apply to residents of both India and Mauritius.” Article 4 of the DTAC defines a resident of a contracting State to mean, “Any person who under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.” The paragraph 2 of the CBDT circular of 13.4.2000 states:

“It is hereby clarified that whenever a certificate of residence is issued by the Mauritius authorities, such certificate would constitute sufficient evidence for accepting the status of residence as well as beneficial ownership for applying the DTAC accordingly.”

12.195 The witness further stated that the legality of this circular of CBDT is already under challenge in the Delhi High Court and CBDT has explained its position in an affidavit filed before the High Court. The Committee were informed in writing that the circular, has been quashed by the Delhi High Court and SLP has been filed in the Supreme Court on the advice of the Solicitor General of India. The Supreme Court has thereafter stayed the order of the High Court in its hearing on 18.11.2002.

12.196 The Committee were also informed by the Department in written replies that MOBAA has since been repealed by Mauritius and Financial Services Development Act has been promulgated with effect from 1.12.2001, which has to some extent removed the drawback of MOBAA, which prevented the Indian Tax authorities from obtaining information under the India-Mauritius treaty due to secrecy clause in MOBAA. The aforesaid new enactment by Mauritius provides for disclosure of information under international treaty, convention or agreement and to similar regulatory agency of a foreign country. The official level Indian delegation which visited Mauritius in 2002 also comprised one Member from SEBI who had discussed draft Memorandum of Understanding (MoU) with the Financial Services Commission of Mauritius for exchange of information on regulator to regulator basis. Further, the Income-tax Act of Mauritius has been amended to give power to the Commissioner there to collect information and exchange the same to the treaty partner under treaty obligations. This amendment has also been carried out in 2001. Based on this change in law, the Mauritius Government assured the delegation visiting Mauritius in July, 2002 that there are no impediments now in the effective exchange of information between the two countries.

12.197 The Committee also requisitioned the relevant files both from the Ministry of Finance (Department of Revenue) and the Ministry of External Affairs and based on the scrutiny of these files certain questions were also addressed to the Hon’ble Minister of Finance as well as Hon’ble Minister for External Affairs who had while replying to the questions, also furnished relevant extracts of various meetings that had taken place from time to time between the Indian and Mauritius side at different levels.

12.198 The Hon’ble Minister of Finance in his written reply furnished to the Committee *vide* his letter dated 25.10.2002 informed the Committee that the Mauritius Government has since amended its laws to allow exchange of information under the treaty obligations. The Mauritian side has also agreed to the Indian view that where the control and management of a company is in India, it will not be a resident of Mauritius but of India and would be liable to tax in India.

12.199 CBDT's role is mainly confined to follow up actions after a scam. If those actions are swift the right message will go to the Stock Market. The Committee note that even after an expiry of almost a decade, the culprits of the 1992 Scam, have not been punished and the cases are still pending adjudication in the Special Courts. The only penalty so far imposed is the monetary one which is reported to be to the tune of Rs.700 crore, and that too has been imposed only on a single Group. Not a single case of Harshad Mehta Group has been finalized and although the assessments in the case of the other group viz. Bhupen Dalal Group have been finalized, no criminal proceedings have been launched against the Group. It is equally serious that against the total outstanding demand of Rs. 11,323 crore, an amount of only Rs. 2203.70 crore, including Rs. 165.70 crore in the case of Fair Growth Financial Services Ltd, has been confirmed, since a large number of cases are reported to be still pending with CIT(Appeals). Only a paltry sum of Rs. 292 crore has so far been recovered. The property worth Rs. 3106.80 crore which stands attached and which includes mostly shares has also not been disposed of despite the fact that a scheme in this respect stands approved by the Special Court as far back as in September, 2000 and a Disposal Committee headed by the custodian for its proper implementation, was also constituted.

12.200 Though the Department of Income Tax while putting forth defence for this tardy progress has blamed the brokers for not finalizing their accounts and getting them audited by the auditors, the fact that the Department also did little in making concerted efforts towards progressing the case can hardly be ignored. It is amply clear that before 1998 no serious effort was made by the Department in this direction. It is all the more disheartening to find that only two Courts are functional. The Committee are of the considered view that unless the guilty are brought to book expeditiously, nothing is going to deter the perpetrators of crime or inculcate a sense of confidence among the investors. It is therefore essential that the assessment orders are finalized, demand raised, pending appeals decided and those who did not deliberately disclose the income, be prosecuted without further delay. Besides, it is equally essential that more Special Courts be made operational so that the long pending cases can be disposed of speedily. This chapter finds place in the report specifically to emphasize the importance of speedy justice.

12.201 The Committee note that the JPC investigating the security scam of 1992 had recommended that a Special Cell may be constituted to investigate the role of big industrial houses and to expose the nexus between banks, brokers and promoters in engineering the 1991-92 securities scam. The Cell which was constituted thereafter in June, 1994, headed by DGIT (Inv.), Bombay virtually stopped functioning after having five meetings, the last being in May, 1995. The Committee are concerned to find that the Cell went into hibernation in the last six years and what is more intriguing is that it met only on 31.7.2001, when the matter came up before the present Joint Parliamentary Committee. The Committee express their displeasure at the way the Special Cell functioned. They recommend that responsibility for this laxity should be probed.

12.202 The Committee note that a Convention for the avoidance of double taxation and fiscal evasion with respect to taxes of income and capital gains was entered into between the Government of India and the Government of Mauritius and notified on 6.12.1983. Its main object was to give encouragement to mutual trade and investment. The convention applies to persons who are residents of one or both of the contracting States. As per Article 2 of the Convention, the taxes to which it applies in the case of India are the income tax including any surtax imposed under the Income tax Act, 1961 and the surtax imposed under the Companies (Profits) Surtax Act, 1964. In the case of Mauritius, the convention applies to 'Income Tax'. The Article further stipulates that the Convention also applies, in addition, to any identical or substantially similar taxes which are imposed by either contracting State. Article 13 gives the right of taxation of capital gains only to that State of which the person deriving the capital gains is the resident.

Under Article 4, the term 'residence' has been defined, as any person who under the laws of that State is liable to taxation by reason of his domicile, residence, place of management or any other criterion of similar nature. Mauritius, however, has no capital gains tax imposed under its law.

12.203 The Committee note that the year 1992 was marked by two significant developments both in Mauritius and India. One was the enactment of Mauritius Offshore Business Activities Act (MOBAA) by Mauritius and the other was the opening up of Indian economy inviting Foreign Institutional Investors (FIIs) to invest in the Indian Capital Market. It was primarily with an object of regulating offshore business activities from within Mauritius that MOBAA was enacted and after this, the 'residence' clause acquired greater meaning since the nature of residence changed in Mauritius. The Committee note that it was after the enactment of MOBAA that significant inflow of funds was started by the Off-shore companies situated outside India who in order to save capital gains tax and taking advantage of the 'residence' clause opened subsidiaries in Mauritius and started investing in India through the Mauritius route even when the main business activities were confined to a third country outside Mauritius.

12.204 From the evidence placed before the Committee it becomes amply clear that some of these companies were having only negligible paid up capital and these were in fact post-box companies. Some of the Indian corporate Groups also took the overseas corporate route and set up subsidiaries in Mauritius. The fact of the possible revenue loss incurred on account of offshore companies using the Mauritius route by claiming residence in Mauritius and not paying capital gains tax in India, was realized way back in 1993, when the issue was raised by the Department of Revenue. However, the efforts to re-negotiate the treaty could not make much headway as the entire Mauritius financial offshore sector was based on India related business and any move to change the Treaty provisions would have resulted in diversification of these funds to other markets. Since then the Committee find that sustained efforts were made by the Government of India including the constitution of a Joint Working Group in 1996 and the matter was taken at the highest level in order to express the concerns relating to misuse of the provisions of the Treaty but due to the special relationship which India enjoys with Mauritius and due to very close political and strategic partnership and also in view of the fact that India has entered into similar treaties with a number of other countries, and Mauritius alone could not be singled out for that matter, the provisions could not be reviewed.

12.205 The Committee find that though the exact amount of revenue loss due to the 'residency clause' of the treaty cannot be quantified, but taking into account the huge inflows/outflows, it could be assumed to be substantial. They therefore recommend that Companies investing in India through Mauritius, should be required to file details of ownership with RBI and declare that all the Directors and effective management is in Mauritius. The Committee suggest that all the contentious issues should be resolved by the Government with the Government of Mauritius urgently through dialogue.

## CHAPTER XIII

### THE MINISTRY OF FINANCE

The Ministry of Finance (MoF) is vested with the overall responsibility for the entire formulation, presentation to the Cabinet, adoption and subsequent implementation of the fiscal, economic and monetary policies of the Government. As part of its implementational responsibility, it oversees the working of the country's financial systems, including the financial institutions, all NBFC companies, capital market and its health. The policy for taxation (direct and indirect), tax collection and distribution, international negotiations, exchange rates, management of balance payments are also amongst the diverse responsibilities of this Ministry. It has the following departments:

1. Department of Economic Affairs
2. Department of Revenue
3. Department of Expenditure

Lately, the Department of Company Affairs, earlier part of Ministry of Law and Justice, has been attached to the Ministry of Finance.

13.2 Different aspects relating to overall responsibility of Ministry of Finance have been dealt with under relevant chapters of this Report. This Chapter relates to the overall responsibilities of the Ministry of Finance towards stock market scam. The role of Ministry of Finance towards the problems of the Unit Trust of India has been separately dealt with in Part II of this report. The earlier JPC of 1992 which enquired into irregularities in securities and banking transactions, in para 16.62 and 16.63 of their report regarding the responsibilities of the Ministry of Finance had observed as under:—

"16.62 The FM has raised a point to which the Committee feel it should react. In his written submission the Minister has stated:

"As regards the functions of the FM, he oversees the work of the Ministry and provides overall policy guidance to the officials. Revenue and Expenditure decisions are the direct responsibility of the Finance Ministry. As such FM has more direct responsibility in these areas. He is also responsible for broad policy decisions affecting the financial system where the Finance Ministry is involved. However, FM cannot be held responsible for administrative failures or management deficiencies in the case of individual banks and other financial institutions."

The Committee feel that such a distinction cannot be sustained by the constitutional jurisprudence under which the parliamentary system works.

16.63 The principle of constructive ministerial responsibility is equally applicable to other Departments and Ministries where acts of omission and commission have taken place in the discharge of function and duties at different levels."

**13.3 The Committee are agreed that ministerial responsibility in regard to this Report flows from these principles.**

#### **I. CAPITAL MARKET DIVISION OF THE MINISTRY OF FINANCE—FUNCTIONS AND RESPONSIBILITIES**

13.4 In pursuance of the recommendation of the earlier JPC of 1992 and with SEBI coming in as the major regulator of the stock market, the Stock Exchange Division of the Ministry was done away with. The total workload was given to the Capital Market Division which formed part of the Department of Economic Affairs.

13.5 Speaking on the role of CM Division in the Ministry of Finance, Shri Ajit Kumar, the then Finance Secretary stated as under:—

“I just wanted to mention very broadly that in 1947, the Controller of Capital Issues Act had been promulgated and under that, we used to have an officer called the Controller of Capital Issues, and it was his job and that of his office to allow all the capital issues—how many are to be allowed, at what price and so on and so forth. Till 1992, this was the position. In between, before that, the Securities Contracts Regulation Act was in position in 1956. Then, when SEBI came into existence, this office of Controller of Capital Issues was abolished and all the functions, which this office used to perform, were given over to the SEBI as the regulator.”

13.6 The Capital Market Division deals with broad policy matters, legislative business relating to any amendment required in Securities Contract Regulation Act or other connected Acts, answering parliamentary questions, coordinating various aspects, servicing the High Level Coordination Committee on Financial & Capital Markets (HLCCFCM) which has been set up under the chairmanship of the Governor of the RBI. This Division deals with organizational matters relating to UTI and SEBI and Securities Appellate Tribunal (SAT) including appointment of Chairman and Members of the SEBI Board.

#### **II. BANKING DIVISION—FUNCTIONS AND RESPONSIBILITIES**

13.7 Within the broad framework explained above prominent functions of the Banking Division of direct relevance to the subjects under examination of the JPC include, *inter-alia*:

- Processing of appointments of Chief Executives of banks and financial institutions and other official and non-official directors on their boards;
- Supervision and appraisal of the overall performance of all public sector banks;
- Policy relating to private banks, foreign banks and NBFCs;
- Policy matters relating to credit;
- Resolving disputes between various departments of Government, PSUs and the banks;
- Nominations of CVOs in public sector banks in consultation with the CVC;
- Vigilance Surveillance over Chief Executives of public sector banks and financial institutions; and
- Studies in Preventive intelligence.

#### **III. SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)**

13.8 SEBI is governed by SEBI Act, 1992 and is accountable to the Parliament through the Ministry of Finance. The SEBI is required to furnish an annual report and annual statement of

accounts giving a true and full account of its activities, policies, programmes and finances to the Central Government which are laid before each House of Parliament. It is through this method that Parliament becomes aware of the functioning of SEBI every year. SEBI is entrusted with the task of protecting the interests of investors in securities and to promote the development and regulation of the securities market through appropriate measures. Under Section 4 of the SEBI Act, the Board of members of SEBI consists of a Chairman, two members from amongst the officials of the Ministries of the Central Government dealing with Finance and Law, one member from the Reserve Bank of India, two other members appointed by the Central Government, who are professionals and inter alia have experience or special knowledge relating to securities market. In practice, however, the senior level positions in SEBI have been held predominantly from Income Tax Department/Indian Administrative Service on deputation basis.

13.9 The Government representatives on the SEBI Board were expected to maintain flow of information between the Ministry of Finance and SEBI as also to project the Government policy on the SEBI Board. However, as the functioning of SEBI reached a level of maturity, the Government expected to give more and more autonomy to that institution. The Board of SEBI was meant to be autonomous regulatory body and this fact has always been recognized. Final decision on any issue within the ambit of the SEBI Act vests with the Board.

13.10 Speaking on the issue of importance of autonomy and distancing politics from economic decision making, Dr. E.A.S. Sarma, former Secretary, Department of Economic Affairs during his deposition before the Committee submitted that the procedures regarding appointment to the top positions in organizations like SEBI, UTI and Banks are not very transparent. He suggested for a Search Committee or a Professional Group which should search professionals for appointment to top level positions. He further suggested that such Search Committee's composition must be defined and the recommendations of the Search Committee should be binding on the government. Constitution of such a committee should be provided in the relevant statute of an organization. On being asked by the Committee what could be the composition of such Search Committee, he suggested that it may comprise Prime Minister, the Leader of the Opposition and the Chief Justice of India so that nobody could question the integrity of the Committee.

#### **IV. VOLATILITY IN THE STOCK MARKET**

13.11 In 1999, the Capital Market witnessed an increase in the Sensex which continued in early 2000. The BSE Sensex which was 3740 on 31.3.1999 rose to 5001 in 31.3.2000 and declined to 3604 on 30.3.2001. From mid-2000 the stock prices showed a declining trend which was gradual but steady. From March 2001 the Sensex fell sharply and can be construed as a crash in the stock market.

13.12 The rise in the Sensex over a period of more than nine months from July 1999 to March 2000 was unprecedented by Indian standards. The graph generally matched the rise of stock market prices in the international markets. The pattern of rise and fall in the international stock market gets generally reflected with minor variations in the Indian stock market also. However, the rise in Indian markets was associated with a massive increase in the daily turn over in stock markets from a few hundred crore to Rs.12000 crore and more. It is normal for stock market to rise and fall. By themselves, such fluctuations do not constitute a scam. However, if the volatility is unusual, the need for enquiring into such market behaviour is imperative. In that context, a question arises as to whether the unusual rise in the prices of shares of certain Information, Communication and Entertainment (ICE) companies was not fueled by irregular flow of money into the stock market. If this was so, then is it not a failure of SEBI and was not the Ministry of Finance duty-bound to ask serious questions about this trend?

13.13 In this regard the Ministry of Finance has stated that while fluctuations are normal in stock markets and should not be a matter of undue concern, the market regulator and stock exchanges concerned need to be vigilant with regard to the systemic risk or movements driven by any form of manipulation. The objective of the Government and the market regulator is to ensure efficiency and integrity in the functioning of the capital markets. As per statutory provisions, surveillance functions over the capital market operations have been assigned to SEBI and the statute does not envisage direct interference by the Government in operations of the capital markets and stock exchanges. However, regular periodic reports are received from SEBI and suitable enquiries are made regarding the functioning of the markets. Successive Ministers of Finance since the commencement of liberalization have testified before the Committee that they kept themselves informed of market developments and enquired, or caused enquiries to be made about reasons for unusual volatility when this occurred. The Hon'ble Shri Yashwant Sinha, vouchsafed the Committee that when the Sensex crossed the 6000 mark in February, 2000, the SEBI chairman even interrupted a Budget meeting to telephonically inform Finance Minister of his concern and Finance Minister asked him to take steps to cool the market. Key steps taken by SEBI in this regard have been elaborated in the chapter on SEBI.

13.14 As per the documents received from the Ministry, taking note of the high degree of volatility in the capital market, the Secretary, Department of Economic Affairs in his letter addressed to SEBI on 26.4.2000 expressed concern about the scope for market manipulation by unscrupulous players in the market. A note was also forwarded containing the following suggestions for bringing improvements in the equity market:—

- (i) Moving all scrips to the rolling settlement mode as soon as possible.
- (ii) Simplification of the margin system and strict implementation of margin requirements that can be verified through an electronic surveillance system so that requirements do not have to be changed frequently.
- (iii) Reviewing the 8% share specific, circuit breaker system already under consideration of SEBI be expedited.
- (iv) The index futures market may be started as soon as possible. This will give market participants access to an additional hedging instrument. This could be followed up, after completing due diligence with the stock exchanges, by initiating a stock options market.
- (v) It is understood that some brokers continue to trade on the telephone well after the stock exchanges have shut for the day. It is also heard that there is substantial "kerb" badla market in Calcutta outside the stock exchange. SEBI may like to take a close look at the market manipulation ramifications, if any.
- (vi) In some equity markets of the developed countries short selling is not permitted when there is excessive volatility on the "downtick". SEBI may like to look into the possibility of introducing a similar restriction in our markets. There is a feeling amongst market functionaries in India that such a restriction would reduce the possibility of panic selling.

13.15 The copies of correspondence held by the Ministry of Finance with SEBI on the systemic reforms from April 2000 were made available to the Committee. It is observed therefrom that the Ministry has been repeatedly emphasizing the need for expeditious corrective measures for effective regulation and controlling high degree of volatility in the stock market.

13.16 During deposition before the Committee, the representative of the Capital Market Division submitted that the Government was aware of the sharp rise in the stock market indices

and that prices of specific stocks had gone up. He informed the Committee that the Government was in touch with SEBI suggesting them to watch out issues like rolling settlement, badla and investor education. A number of questions on this subject were asked in the both Houses of Parliament. The Capital Market Division of the Ministry of Finance was in touch with SEBI "at that point of time." They were also watching NASDAQ and while "that was not necessarily the full explanation of what was going on in this market but we saw that the Information, Communication and Entertainment (ICE) companies, their share prices were relatively going even higher." The representative of the Capital Market Division further stated that "SEBI has got back to us saying that they have repeatedly issued signals through a variety of ways to the investors to be careful given the fact that stock valuations are very high."

13.17 In the statement by Shri D.R. Mehta, the then Chairman, SEBI submitted to the Committee during his deposition on 13.9.2001, it was stated that:

"On three different occasions, SEBI issued press releases cautioning small investors to exercise utmost caution and diligence including verification of fundamentals while transacting in securities."

13.18 The Capital Market Division representative also mentioned that they were informed by SEBI that the SEBI has repeatedly issued signals through a variety of ways to investors to be careful to invest in the companies which have low floating stocks and in which there might be already some issues under investigation by SEBI.

13.19 However, there was inadequate monitoring by SEBI as to whether its directives for investor protection were being assiduously implemented. Moreover, there was tardy reporting of compliance by Stock Exchanges, and neither SEBI's nominees directors nor SEBI itself cross-checked the reassuring reports received from Stock Exchanges against the concerns of the SEBI and the Ministry of Finance which led to the SEBI's circulars. Nor there were any concerted efforts by the regulators or the Ministry to monitor or investigate the exponential rise in the flow of money into the stock market from domestic and international sources. Therefore, there was inadequacy in action taken to identify issues relating to the integrity of markets and the protection of investor interests calling for corrective action through the strengthening of regulatory framework. The regulatory framework has now been considerably strengthened but only after the crash of March-April, 2001.

**13.20 It is thus observed that the Ministry of Finance have been repeatedly emphasizing the need for expeditious corrective measures for effective regulation and controlling the high degree of volatility in stock market. Actions taken by Ministry of Finance and SEBI to warn investors during the rise of stock prices have been noted by the Committee. It has also been noted by the Committee that there was a feel good factor and feeling that India had arrived on the IT scene. Although actions have been taken by the Ministry of Finance and SEBI during the period when the stock market was rising unusually, the Committee are of the considered view that both these should have been more proactive and vigilant.**

13.21 The Finance Minister while giving his statement in the Parliament on the extreme volatility in the stock market on 13.3.2001 stated that SEBI had already started its investigation as far as price manipulation was concerned and he announced following measures to improve institutional mechanisms and trading practices in the stock market:

- (a) Corporatisation of stock exchanges by which ownership, management, and trading membership would be segregated from each other. This would help towards professionalisation of the management of exchanges, enhancing the ability of stock

exchanges to raise funds from the market to modernise exchanges and providing better investor service;

- (b) Extension of rolling settlement to 200 category "A" stocks in Modified Carry Forward Scheme, Automated Lending and Borrowing Mechanism and Borrowing and Lending Securities Scheme by July, 2001;
- (c) Legislative changes to further strengthen provisions in the SEBI Act, 1992 to promote investor protection.

13.22 Regarding the implementation of the aforesaid measures so announced by the Finance Minister, it has been mentioned in the annual report for the year 2001-2002 of the Ministry of Finance that:

"As regards coporatisation/demutualisation of stock exchanges, there have been consultations between Ministry of Finance, SEBI, Ministry of Law, Department of Company Affairs and stock exchanges. SEBI Board, in its meeting dated 28.12.2001 decided that no broker member of the stock exchanges shall be an office bearer of an exchange *i.e.* hold the position of President, Vice President, Treasurer etc. and that no SEBI official would be nominated on the Board of stock exchanges. Following this, SEBI has issued an order dated January 10, 2002, under Section 8 of the Securities Contracts (Regulation) Act, 1956, directing all the recognised stock exchanges to suitably amend its Rules, Articles etc. within a period of two months to give effect to SEBI Board's decision. The other administrative and legal modalities for demutualisation of stock exchanges are being worked out. In case of 11 stock exchanges, which failed to amend Articles or Rules to comply with the above referred SEBI Directive, the Articles or Rules of these exchanges were amended by SEBI through a notification. The other complex administrative and legal modalities for demutualisation of stock exchanges are being worked out. A Committee, under the Chairmanship of Justice Kania was constituted by SEBI to provide a definite road map for the early completion of the process of demutualisation.

Further the rolling settlement was extended to 251 category "A" stocks in Modified Carry Forward Scheme, Automated Lending and Borrowing Mechanism and Borrowing and Lending Securities Scheme on 2.7.2001. From 31.11.2001 rolling settlement has been extended to all scrips on all stock exchanges. All deferral products have been discontinued from 2/7/2001. Legislative changes for amending the SEBI Act 1992 to make SEBI a more effective body for regulation and development of capital market and for protection of investors are being proposed by the Government."

**13.23 The Committee underline the necessity for early implementation of corporatisation/demutualisation of Stock Exchanges process.**

13.24 Commenting on the accountability of the regulatory authorities and the accountability of the Ministry of Finance to Parliament on the lapses on the part of regulators, the Secretary, Department of Economic Affairs, submitted:

"...The general approach of the Government has been to try to instil into the regulators professionalism. The general approach is also to have systems, to have people who are knowledgeable in their respective sectors, who can run these regulatory bodies as professionals and frame regulations which are in line with the best practices insofar as regulation of their respective financial sector instruments are concerned. The Government, I think, does want to give maximum managerial, functional autonomy to the regulators so that they can perform their functions in a professional manner without any back-seat

type of driving in its day to day operations by the Government. ...But obviously autonomy cannot be divorced from accountability. The dividing line of accountability, in a very micro sense, is the day to day reporting or monthly reporting, weekly reporting; how many cases they have done etc. The other thing is a macro type of an accountability, getting annuals reports, half-yearly reports and overall performance. ...But certainly I would not say that the solution would be more micro type of interference or accountability to Government on a day to day basis."

13.25 With respect to giving more powers to SEBI to enable it to have a better regulatory control over the Capital Market, the Secretary, Department of Economic Affairs stated :

"We have done a fairly detailed study of the powers of SEBI and the powers which are there with regulators of capital market in other countries, and we have also come to this conclusion that we do need to vest SEBI with certain more powers for doing better investigation. Today, it cannot have easy access to various documents and other things which are needed for doing effective investigation. Its powers to impose penalties are also not deterrent enough. So, regarding the investigative powers of SEBI and powers to impose penalties, on the basis of study of powers which are there with other regulatory entities which are doing similar jobs in other countries, we have formulated proposals for vesting SEBI with more powers, which are currently under consideration in the Government and which the Cabinet would be discussing soon. If they are cleared then, we would be placing the Bill for consideration of Parliament also. But we have also agreed with SEBI that it does need to be given some more teeth in that sense."

13.26 The Ministry of Finance had submitted that the Government has initiated examination of possible legislative changes aimed at further strengthening the SEBI Act, 1992 for investor protection and to make SEBI a more effective body for regulation and development of capital markets. The Ministry of Law and Justice (Legislative Department) notified Ordinance (No.6 of 2002) on 29.10.2002 to further amend the SEBI Act, 1992. According to this Ordinance, the number of members on the SEBI Board has been increased from the existing 6 members to 9 members including the Chairman. In addition to this, additional powers as detailed in the chapter "Powers of SEBI" have now been conferred on SEBI to give it more teeth. These enhanced powers would enable SEBI for carrying out effective investigation by having easy access to various documents, impose enhanced penalties and also conferring on it the power of search & seizure etc. Further, under the Ordinance the Securities Appellate Tribunal has now been made a multi-member body.

## **V. ISSUES RELATING TO BANKING SECTOR**

13.27 The functions and responsibilities of the Banking Division in the Department of Economic Affairs of the Ministry of Finance is given at Para 13.7 *ante*. Thus, the Banking Division monitors the overall functioning of public sector banks, UCBs and rural cooperative banks in the country. It also reviews all circulars/directions issued by RBI to cover banks/cooperative banks and non-banking financial companies and gives necessary advice to RBI in this regard. The Banking Division is not concerned with operation of individual banks for loaning and investment including capital market operations. This function is carried out according to the decisions and policies laid down by the Board of the respective banks under the guidance of the RBI.

13.28 As per the provisions of RBI Act 1938, the general superintendence and directions of the affairs and business of the banks has been entrusted to the Central Board of Directors of RBI. While the Central Government has powers to give such directions to the banks as it considers necessary, after consultation with the Governor of RBI, it has been the endeavour of the Finance

Ministry not to interfere in the day to day affairs of the banks. The Government has a nominee on the Board of RBI. Government of India also does not directly monitor the performance of the banks. This function has been entrusted to the Reserve Bank of India who is regulator of the banking sector. If any adverse feature about the working of any bank is brought to the notice of the Government by the Reserve Bank of India, the Government takes necessary remedial measures as are necessary.

13.29 The Ministry of Finance in their reply to a question regarding comparison between the 1992 scam and the present scam regarding the role of the banks, submitted that the irregularities in securities transactions uncovered in 1992 involved complex and interconnected transactions between public sector banks, private sector banks, foreign banks, co-operative banks and financial institutions. The major contributing factor of these irregularities was that transactions in Government securities were undertaken in physical form and not in dematerialized form. Based on the recommendations of the earlier JPC (1992), a number of measures have been taken by the Government of India and the Reserve Bank of India (RBI) to address the systemic deficiencies, which contributed to the irregularities. The measures so taken had insulated to a large extent the Government Securities market from the irregularities observed earlier. The irregularities observed in 2001 are mainly of a fraudulent nature undertaken by a few small private sector banks and co-operative banks in collusion with the stockbrokers. The irregularities noticed now have not so far revealed any systemic deficiencies but are basically violations of RBI instructions.

13.30 The SEBI informed the Committee that it has been concerned with the need for having a centralized monitoring mechanism for the flow of funds from the banking sector into stock markets. This matter was discussed as agenda item No.3 in the High Level Coordination Committee on Financial & Capital Markets (HLCCFCM) on 16.8.2001. The specific suggestion made by SEBI was that there is a need for a central authority to monitor the flow of funds into the stock markets, brokers should be required to disclose the source of their funds to a centralized authority for trading in excess of a certain limit and these requirements should be made applicable to clients also. After considering this agenda point, the High Level Coordination Committee observed that as per the SEBI's preliminary investigation into the current market crisis an observation was made on the procurement of large funds from the banks by some broker entities involved in market manipulation. It was found that apart from funding by promoter groups to the brokers, substantial funds were given by certain banks to the broking entities associated with Ketan Parekh. The pattern of acquiring substantial funds from the banking system leading to the arrest of Ketan Parekh by CBI in connection with Pay-order fraud suggests misuse of the banking system.

**13.31 A number of legislative proposals have been initiated by RBI and have been discussed in detail under the chapter "Reserve Bank of India" of this report. The Committee are constrained to observe that there have been serious delays at both the regulators' end and in the Ministry of Finance and other Ministries concerned in processing legislative proposals for strengthening the regulators and endowing them with more punitive powers. The Committee deplore the delays in Government in processing the legislative changes proposed by the RBI with the dispatch that they deserve.**

13.32 Regarding the implementation of recommendation of the earlier JPC of 1992 securities scam that statutory provision be made with regard to bouncing of SGL transfer forms as penal offence as in the case of cheques, the Ministry have informed that the same has been accepted and accordingly, the Public Debt Act, 1944 is being repealed and enabling provisions have been proposed in the Government Securities Bill. Further, a new section has been inserted for levy of penalties. According to the Ministry, the enactment of the proposed new legislation can be done after passing of the requisite Resolutions by the State Legislatures. In this regard, the

Ministry has informed that the concurrence of all State Legislatures has since been obtained and accordingly, a Draft Cabinet Note alongwith draft of the proposed Government Securities Bill approved by Finance Minister has been sent to Department of Legal Affairs for comments/ concurrence on 11.2.2002. The matter was further discussed with that Department by concerned officers of the Ministry of Finance and RBI in a meeting held on 21.5.2002. In order to expedite concurrence of the Department of Legal Affairs, a reminder was issued *vide* D.O. letter dated 21.6.2002. The file was received back on 29.7.2002 from Department of Legal Affairs, for some clarifications. It is expected that the Bill will be introduced in the winter session (2002) of the Parliament.

## **VII. HIGH LEVEL COORDINATION COMMITTEE ON FINANCIAL AND CAPITAL MARKETS (HLCC)**

13.33 This Committee was constituted for ensuring greater coordination among the regulatory agencies in the financial and capital markets and to meet regularly to review the position regarding financial/capital markets. The functions of HLCC as reported by the Ministry of Finance to Parliament in its ATRs of 1994 are as follows:

“In May 1992 the Finance Ministry set up a High Level Coordination Committee on Financial and Capital Markets under the Chairmanship of Governor, Reserve Bank of India and including Chairman, SEBI and Secretary, Department of Economic Affairs as members. This Committee has been set up for ensuring greater coordination among regulatory agencies in the Financial and Capital Markets and meet regularly to review the position regarding financial/capital markets.”

13.34 The Committee has been meeting at regular intervals since May, 1992 under the Chairmanship of Governor, RBI with Secretary, Economic Affairs and Chairman, SEBI as members. In October 2000, Chairman, Insurance Regulatory Development Agency was included as member of the Committee. The Capital Market Division in the Ministry of Finance functions as the Secretariat of this Committee. A Standing Committee on Capital Market has been constituted by the HLCC to examine capital market policy issues as required, put up the agenda for HLCC meetings and follow up on its decisions. The members of the Committee are an Executive Director each from SEBI and RBI.

13.35 At a recent meeting on 27.5.2002, HLCC recommended to the Government that:

“HLCC is not a monitoring body but only coordinate issues as and when required. The Committee would meet as and when required to resolve policy issues at regulator’s level

- Wherever a specific regulator feels that an issue requires inter-agency consultation.
- Any other issue which in the opinion of the Ministry of Finance requires consultation with the regulators”.

Until government takes a view on this recommendation, the terms of reference of HLCC remain as set out in the 1994 ATRs submitted to Parliament.

13.36 In response to the Committee pointing out that HLCC appears to have played almost no role in checking the behaviour of the stock market during the period 1998-2002 and to know whether HLCC had functioned as a forum in which the regulatory authorities of different kinds and authorities responsible to Parliament actually coordinated their work, the response of the Secretary, Department of Economic Affairs was:

“Frankly HLCC is as it is presently constituted, my understanding is that it has not been given the responsibility of advising Government or looking into macro policy type of

issues. The role of this HLCC is just the coordination amongst the activities of different regulators in the financial sectors, and to the extent there is an interface with the Ministry of Finance with the regulators. This is more a forum where regulators sit among themselves and exchange information, where there is an overlapping of the regulating regime of one regulator and another regulator.”

13.37 Since the issue of 1992 scam report, the meetings of the HLCC were held as under:—

Year	Name of the Chairman (Governor, RBI)	No. of sittings held
1993	Shri C. Rangarajan	3
1994	Shri C. Rangarajan	3
1995	Shri C. Rangarajan	6
1996	Shri C. Rangarajan	2
1997	Shri C. Rangarajan	2
1997	Dr. Bimal Jalan	1
1998	Dr. Bimal Jalan	2
1999	Dr. Bimal jalan	1
2000	Dr. Bimal jalan	3
2001	Dr. Bimal Jalan	3
2002	Dr. Bimal Jalan	1 (As on 27.5.2002)

**13.38 A perusal of the working of the HLCC indicates that this Committee concerned itself with the co-ordination aspects only. The Committee did not go into the general situation of the economy or the stock market and did not make any recommendations excepting those that related to actions to coordinate activities of various regulators like RBI, SEBI, DCA etc.**

#### **VIII. ISSUES RELATING TO OCBs AND FIIs**

13.39 The Government of India decided to introduce a package of measures to facilitate remittances of investments by NRIs/persons of Indian origins which was announced by the Finance Minister in his Budget Speech on 27.2.1982. The Portfolio Investments Scheme (PIS) for NRIs/OCBs formed a part of the package measures. In formulating the PIS scheme at that time, the Government had three considerations:—

- (a) As much flexibility as possible should be available to non-residents for bringing foreign exchange into India and the concern should be the purpose of investments rather than legal entity of the non-resident investor of Indian origin,
- (b) It was to be ensured that the benefits of the scheme should not be available to non-resident persons or overseas bodies other than those of Indian nationality/origin, and
- (c) The investment of funds under the scheme should not lead to take over of existing companies through operations in the stock market.

13.40 In April, 1982 the PIS was extended to OCBs and in September, 1983, the definition of OCBs was modified by the Government and extended to cover even indirect ownership to the extent of at least 60% by NRIs. In June, 1998 the scheme was modified by the Government to

enhance the individual and aggregate portfolio investment ceiling for NRIs/OCBs. Individual investment limit was raised from 1 per cent to 5 per cent and aggregate limit was raised from 5 percent to 10 percent of the paid up equity capital of the Indian company. Further, in order to provide a greater margin of flexibility for NRIs/OCBs, the scheme was, simultaneously, modified to provide for an exclusive aggregate investment limit for NRIs/OCBs and a separate aggregate portfolio investment ceiling for FIs.

13.41 A convention for avoidance of double taxation and prevention of fiscal evasion with respect to taxes of Income and Capital Gains was entered into between India and Mauritius on 6.12.1983. In August 1993, CCIT Mumbai brought it to the notice of the CBDT that some asset management companies were using the treaty with Mauritius for preferential treatment and accordingly the matter was taken up with Mauritian authorities to ensure that the benefits of bilateral tax treaty were not allowed to be misused. Then, in March 1994 a clarificatory circular was issued laying down that any resident of Mauritius deriving income from alienation of shares of Indian companies would be liable to capital gains tax only in Mauritius and will not have any capital gains tax liability in India. Then again on 13.4.2000 another circular was issued by CBDT to its assessing officers *inter-alia* clarifying that a certificate from Mauritian authorities would be a sufficient proof that a taxpayer was resident in Mauritius, which was struck down by the Delhi High Court on the ground that an administrative circular could not abridge the rights granted to an assessing officer under the Income Tax Act to investigate further the true residence of a taxpayer. The SLP filed by the Government has been admitted by the Supreme Court and the order of Delhi High Court has been stayed.

13.42 As regards FIs, the Ministry have submitted that FIs were allowed to invest in Indian Capital Market in terms of Government of India guidelines for Foreign Institutional Investors (FII) dated 14.9.1992, stipulating overall ceiling of 24% on the investment by FIs together with NRI/OCB investment in the secondary market, in the total issued and paid up capital of an Indian company. Further, SEBI came out with the SEBI(FII) Regulations in November, 1995 which covered exhaustively various aspects such as eligible categories, securities in which FIs can invest, ceilings on their investment and procedure for making applications for obtaining permission under FERA from RBI and registration with SEBI.

13.43 As regards the misuse of Portfolio Investments by NRI/OCBs, it has been decided by RBI notification dated 29.11.2001 that, henceforth, Overseas Corporate Bodies (OCBs) shall not be permitted to invest under the Portfolio Investments Scheme (PIS) in India. OCBs will however continue to enjoy the facilities of opening non-resident accounts and making direct investment as permitted so far. Further, the OCBs that have already made investment under the PIS, may continue to hold such shares/debentures till these are sold on the Stock Exchange.

13.44 The various issues concerning the misuse of PIS by OCBs and regarding investments by FIs and OCBs in the Indian securities market using the tax free Mauritius Route have been extensively dealt with in the chapters on "OCBs and FIs Sub-account" and "CBDT" of this report.

**13.45 The Ministry of Finance is the nodal authority and co-ordinates the functions of all the departments/organisations working under its administrative control. Regulators are accountable to the Ministry of Finance which, in turn, is responsible to Parliament. All the policy making powers also vest with the Ministry. SEBI, as the independent statutory Regulator, has been endowed with powers to autonomously regulate capital markets. According to the Ministry, the general approach of the Government has been to instil professionalism by having the people who are knowledgeable in their respective fields. The Committee find that SEBI which was set up as a statutory body through an Act of Parliament in 1992 was hitherto being managed at the senior level not by the professionals but by the persons taken mostly from the Income Tax Department/**

Indian Administrative Service on deputation basis. Besides, as per the provisions of SEBI Act, 1992, the SEBI Board consists of 5 members besides the Chairman. The Board is largely dominated by the Government nominees as the Chairman and 2 members are nominated by the Central Government from amongst the officials of Ministry of Finance and Ministry of Law, while one member is nominated by the RBI. The Ministry of Finance have made legislative changes for amending the SEBI Act through an Ordinance in order to give it more teeth for regulating and development of capital market. The Committee are of the view that in order to give true autonomy to the market regulator, there should be complete transparency in the appointment of the Chairman and the members of the Board. In this regard, the Committee agree with the suggestion of the former Secretary of the Department of Economic Affairs that for appointment to the top positions in such organizations including the banks, there should be a Search Committee, whose recommendations should be final and mandatory. In order to give such body a legal sanctity, it is essential that its constitution is well defined and provided under the relevant statute. The Committee therefore, recommend that while amending the SEBI Act, this aspect should also be given serious consideration.

13.46 While accepting that managerial and functional accountability is required to be vested in statutory independent Regulators so that they can perform their functions effectively and without undue interference, the Committee stress that accountability must go hand-in-hand with autonomy and the principles governing the responsibility of the Minister to Parliament in terms of the constitutional jurisprudence under which the parliamentary system works. The Ministry should also evolve appropriate checks and balances to overcome the systematic shortcomings in the present system which has resulted in this scam. The Committee feel that the approach of the Ministry of Finance should be to progressively make SEBI a very effective and efficient regulator of capital market which can inspire confidence amongst various players. The Committee note that recent legislation has now endowed SEBI with the required powers to moderate stock market volatility and inspire investor confidence.

13.47 The Committee recall that the 1992 JPC had drawn attention in paragraph 2.8 of its Report to the "very damaging approach (which) seems to pervade, that of transferring responsibility downwards. This distressing lack of fibre in the apparatus of governance can only debilitate the state." Regrettably, notwithstanding the passage of nearly a decade since that Report, nothing seems to have changed. The culture of governance continues to be pervaded by attempts at transferring responsibility elsewhere. Therefore, the Committee recommend that there must be a clear demarcation of responsibilities between the Regulators and the executive so that there is transparency in the system of accountability.

13.48 The Ministry of Finance, being the financial custodian of the country, is duty bound to protect the interests of the small investors. SEBI has now been endowed with statutory powers under the amended SEBI Act to secure redressal of investor grievances and entitle investors to seek compensation, the award of damages etc. Besides this, Professor L.N. Mitra in his report to SEBI on this issue has also suggested for a separate Act for investors protection, as detailed in Chapter XIV of this Report. The Committee recommend expeditious action on this proposal. Further, in order to deal with vanishing companies and collective investment schemes, SEBI has suggested that Securities Appellate Tribunal (SAT) be empowered to attach properties of such defaulters. The Government has reconstituted the SAT to be a multi-member body which should help in expeditious disposal of cases.

13.49 Regarding demutualisation and corporatisation of the stock exchanges, the SEBI constituted a Committee under the Chairmanship of Justice Kania to provide definite road map for the early completion of the process, which has since submitted its Report. The Committee recommend that the Government must ensure expeditious implementation of the demutualisation and corporatisation process so as to improve management of the exchanges and enabling smooth conduct of business in a fair and non-partisan manner.

13.50 It is imperative that the question of coordination between various Regulators among themselves and with the Government be seriously addressed to by the Ministry of Finance. The Government in their revised Action Taken Report on the implementation of recommendations of the earlier JPC on Securities Scam which was tabled in Parliament in December 1994 had inter alia submitted that the HLCC constituted by the Ministry of Finance in May 1992 had been set up for ensuring greater co-ordination among the regulatory agencies in the financial and capital markets and meet regularly to review the position regarding financial/capital markets. The Committee note that HLCC has not carried out the latter portion of their mandate viz. "regularly review the position regarding financial/capital market." The Committee consider this an unfortunate omission. The Ministry of Finance on its part and in relation to the assurance given by it to the Parliament in its revised ATR has not referred such crucial issues to the HLCC which was supposed to review the position regarding financial/capital markets. Had these issues been taken up by the HLCC periodically, it would have definitely helped in minimizing, if not preventing altogether the irregularities which have surfaced in the present scam.

13.51 Although there is need for better and closer coordination amongst the multiple agencies which are actively involved in our financial system, the Committee are of the considered view that a super regulator is not the answer to the problem. This task can be handled by HLCC and to this end HLCC should be serviced by an efficient secretariat. In addition to its present functions, HLCC should also be mandated to ensure the expeditious implementation of ATRs arising out of JPC recommendations. The Committee also stress the importance of elaborating and detailing the functions of HLCC with regard to undertaking "regular review of position regarding the financial/capital market."

13.52 The Committee note that while the Banking Division monitors the overall functioning of public sector banks and rural cooperative banking system in the country besides reviewing circulars/instructions issued by RBI, it is not concerned with individual operations of the banks as the same are carried out in accordance with the guidelines of the RBI. As per the provisions of the RBI Act, the general superintendence and direction of the affairs of the Banks has been entrusted to the Central Board of Directors of RBI on which the Government has a nominee (generally Finance Secretary). Further, before taking a decision in a matter of larger public interest, RBI consults the Government. However, the Banking Division is responsible for legislative framework relating to the Banking Sector which includes RBI Act, 1934, Banking Regulation Act, 1949, SBI Act, 1955, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, Regional Rural Banks Act, 1976, Public Debt Act, 1944 etc. The Committee however note that a large number of legislative proposals with respect to the Commercial and urban co-operative banks mooted by the RBI are pending consideration in the Ministry. The details of the proposals have already been mentioned in the Chapter on the Reserve Bank of India of this report. The Committee recommend that the Ministry should expeditiously finalise the proposed amendments in the Banking Regulation Act, 1949 and introduce the amended legislation in the Parliament at the earliest.

13.53 The Committee express their concern at the inordinate delay of almost 8 years by the Government in implementing the recommendations of the earlier JPC of 1992 on Securities Scam regarding the framing of statutory provisions with regard to making the bouncing of SGL transfer forms as penal offence as in the case of cheques. Although the said recommendation was accepted by the Government way back in 1994, but so far the Government Securities Bill, in which the statutory provision is proposed to be incorporated is yet to be enacted and the Bill is expected to be introduced in Parliament only during the Winter Session of 2002. As the matter has already been inordinately delayed, the Committee recommend that the Government should expeditiously repeal the Public Debt Act, 1944 and enact the new legislation without further loss of time.

13.54 To contextualise the period in which the present scam surfaced, resulting ultimately in the crash of the stock market from March 2001 onwards, the Committee reviewed the implementation of the recommendations of the 1992-93 Joint Parliamentary Committee which had enquired into "irregularities in securities and banking transactions and found a number of areas in which the recommendations had not been taken seriously. The process of economic liberalization vis-a-vis banking transactions and innovative portfolio management schemes had started almost concurrently with the proceedings of the earlier JPC. Although through the 1982 Budget speech of the then Finance Minister, OCBs had been given the same status as NRIs and PIOs and allowed to invest in India, and in 1992 through the Budget speech of the then Finance Minister, FIIs were allowed to enter the Indian capital market. Modifications in the regulations relating to OCBs since 1982 and FIIs between 1992 and 1999 have not put sufficient risk-hedging regulatory measures in place. Therefore, systemic deficiencies caused by insufficient risk-hedging regulatory measures opened windows of opportunity for brokers, ALMB/BLESS/MCFS players, OCBs/ FIIs etc. Therefore, it is these regulatory lapses which were part of the problem and need focused attention.

13.55 According to the Banking Division, based on the recommendations of the earlier JPC on Securities Scam, a number of measures have been taken by the Government and the RBI to address systematic deficiencies which contributed to the irregularities. However, the steps taken thus far have not forestalled irregularities which have led to large amounts of money being pumped into the stock market and its consequent misuse by certain entities, as detailed in this Report.

13.56 As discussed elsewhere in this report, the Committee are concerned to note that there has been no regulatory framework to monitor the activities of OCBs as these are neither registered nor regulated by SEBI and also are not under the regulatory framework of RBI. The Ministry of Finance being the main policy making body, has not applied their mind in this regard. The Committee note that this issue has currently been addressed by banning OCBs from making any fresh portfolio investment in the securities markets. The Committee are of the view that this may not be a permanent solution and recommend that the Ministry of Finance needs to lay down clear policy guidelines for monitoring the operations of OCBs.

## CHAPTER XIV

### INVESTORS PROTECTION

14.1 The Stock Market plays a crucial role in mobilizing house hold savings. This is particularly important in view of the need to substantially augment savings and investment rates which have been stagnating in the recent past, to attain the ambitious growth targets being set for the 10th Five Year Plan and beyond. An efficient, well-regulated, trust-worthy system of Investor Protection is the key to drawing into Stock Market investment house-hold savings from relatively untapped sources, such as rural areas as well as augmenting Stock Market investments from better-tapped sources. Equally, a strong system of investor protection is likely to induce a higher level of foreign institutional investment in a buoyant Stock Market. In view of this strong link between sound investor protection and a healthy Stock Market, the Committee reviewed in some detail the existing level of Investor Protection.

14.2 In any activity of the stock market and in any scam, sudden drop of SENSEX or decrease in the prices of shares hurts the common investor most. While the common, middle class investor puts in his life savings with a view to earning long term benefits, institutional investors invest to gain quick money and there is a contradiction of interest between the two. Equally, when the institutional investors enter and exit the stock market they increase the volatility of the market. These facts apply equally to investments in the UTI Schemes. Unless the common investor's interests are protected and his confidence in the transparency and fair play of the system is developed it will be difficult to increase the investor base in our stock market. Protection of common investors' interests, therefore, is of paramount importance. Keeping the importance of this subject in view, the terms of reference of the Committee includes, *inter alia*, "to suggest measures to protect small investors." Investor protection being of vital importance, the Committee had inputs from report of Dr. N.L. Mitra of the Centre for Business Law Studies, Bangalore, suggestions made by some of the Investor Protection Associations, written representations by various affected groups and persons and Committee's own observations during the evidence.

14.3 As per the survey conducted by SEBI and NCAER in 1998-99, 19 million individuals have invested in the securities market. Of these 18 million individuals owned equity. It was also revealed that 67% of these were urban investors. 23 million individuals were unit holders in Mutual Funds, many of whom are also investors in equity. Investing households also saw a good growth rate at 22% between 1985 and 1999 with the urban investor population increasing at 19% and the rural investor population increasing at 30%. According to a recent update of the survey by NCAER, there has been a further increase in investor population.

14.4 Public investment has various authorities for the purpose of regulation as for example (a) Reserve Bank of India is responsible for the protection of interest of the depositors and deposits raised by NBFC; (b) SEBI is responsible for investors' protection in the case of listed companies, mutual funds, collective investment schemes and other allocated companies by the Government of India; (c) Department of Company Affairs is responsible for protecting the interest of the investors in unlisted companies and other incorporated institutions, Nidhi companies and deposits by manufacturing companies; (d) Company Law Board; and (e) Stock Exchanges. In a multi-regulatory system there is bound to be gaps in some places and overlap in some other places.

## **N.L. MITRA Report**

14.5 A study on the present standard of the protection of investors' interests and the future need was commissioned by Department of Economic Affairs in cooperation with SEBI and RBI in the year 2000. The study was conducted by Dr.N.L. Mitra of the Centre for Business Law Studies, Bangalore. The Report was submitted on 17.4.2001. The scope of the study regarding investors' protection was confined to corporate investment.

### **A. Separate Act for Investor Protection**

14.6 Dr. N.L. Mitra report has observed that the provisions regarding protection of investor's interests is spread over various Acts. Investment in securities is covered by the Securities Contract (Regulation) Act and the Securities and Exchange Board of India Act. If securities are related to incorporated companies then the Companies Act is involved. The depositors in banks and financial institutions are to be protected by the Reserve Bank of India. The Company depositors' interests are covered by the Companies Act, 1956. Dr. Mitra has, recommended that there should be a separate Act for protecting the investors' interests and also annexed with his report a draft Investor Protection Bill. It has been pointed out that States like Tamil Nadu, Karnataka and Maharashtra have laws already in place regarding investors protection. The Maharashtra Investors Protection Act has provided for imprisonment for six years and fine of Rs.1 lakh along with attachment of movable and immovable assets of the Directors of the fraudulent firm. The Act also envisages appointment of Special Courts.

### **B. Agency for providing compensation**

14.7 The problem of investors' protection arises due to following factors:-

- (i) persons or entities raising fund for specific purposes but not applying the fund for that specific purpose or applying the fund for different purposes without the consent of the people supplying the fund or wrongly applying the fund either negligently or intentionally.
- (ii) Raising the fund knowingly that the fund shall not be used for the purpose of which it was raised and shall be diverted.
- (iii) Raising public funds by cheating or committing breach of trust.

14.8 A representative of Tamil Nadu Investors' Association who appeared before the Committee pointed out that there is no proper coordination among the regulators in redressing the investors grievances and said:

"When problem crops up, the investors are made to run from pillar to post. Absolutely nobody knows who is going to solve the problem. It is absolutely essential, in my opinion and in our opinion as an Association, that we must have a central regulator who takes care of the requirements of the small investors."

14.9 Midas Touch Investors Association has suggested that SEBI should be empowered to award damages/compensation to the investors for the losses suffered by them due to manipulation in prices.

14.10 Dr. N.L. Mitra in his report pointed out that DCA acts as both regulator and as part of the Government and that ideally a government is responsible for the statutory and administrative law and not directly responsible for any regulatory work. In his view, DCA must

not be engaged in any regulatory function. The Secretary, DCA, however, said in this connection:

“I think it would be a very ill thought to say that DCA should have no regulatory authority. SEBI is there in the stock market. SEBI’s job is to look after the proper functioning of the stock market. In fact, whether you see the 1992 scam or the 2001 scam, both of them have grown out of the stock market. It is the stock market which is providing a pool of temptation from various actors to make money or to misutilise funds. In 1992 it was banks which floated the Portfolio Management Scheme and mismanaged the whole thing. Here again, two banks have flowed their money. If the stock market was well regulated and guided properly with warning signals, to a considerable extent this temptation would have been avoided”.

14.11 Dr. Mitra has emphasized that a judicial forum is needed for the redressal of investors’ grievance for the purpose of remedying the same with the award of compensation. He has recommended that Consumers Court or Securities Tribunal should be empowered to provide for compensation to the investors and that there should be provision for awarding compensation by the court/tribunal to the aggrieved investors.

### **C. Restoration of Investor Confidence**

#### **(i) SEBI**

14.12 SEBI has stated that whatever policy it frames is always keeping in mind investor protection. Education, dissemination of information and redressal of grievances of the investors is stated to be the main focus of SEBI.

14.13 The Committee pointed out that investor confidence in the capital market is greatly shaken by the recent scam and asked what steps are taken for restoring the investor confidence and to provide more safeguards for small investors in the stock market. In a written reply SEBI has stated that it has been continuously taking measures for protecting the interest of the investors in the securities market. Some of these include risk management systems such as margin requirements, price bands and circuit breakers, dematerialisation, establishment of clearing houses and settlement guarantee funds in stock exchanges to ensure that there is no settlement failure, establishment of investor protection funds in the stock exchanges, increasing the disclosure requirements, introducing continuing disclosure requirements including quarterly disclosures of financial results, introducing corporate governance measures to raise the standards of corporate governance in the companies and strengthening the accounting standards by reporting, deferred tax liability and related party transactions. SEBI has also been taking actions against market intermediaries for regulatory violations which include market manipulation and unfair trade practices. SEBI is also continuously reviewing the aforesaid measures to further strengthen them. SEBI also pointed that investment in stock markets are per-se risky and the stock prices may go up or down. No insurance could be provided to any investor against uncertainties in the market and investors would, therefore, have to make informed investment decisions. The measures adopted by SEBI have been designed to enable investors to take such decisions.

14.14 When asked what measures SEBI has taken to ensure only good quality issues approach the market and to keep the issues of dubious promoters out of the market, SEBI in its written reply has stated that it has stipulated the following guidelines:-

- (i) Companies proposing to access the markets have to make substantial disclosures as prescribed in the SEBI (Disclosure and Investor Protection) guidelines.

- (ii) The guidelines stipulate eligibility norms for issues. To ensure that good quality issues come to the market, the norms have been recently tightened.
- (iii) SEBI makes the offer document public for its comments. If there are any shortcomings or negative aspects, they could be brought to the notice of SEBI by any person.
- (iv) In order to ensure commitment of promoters, the guidelines for IPOs stipulate lock-in for promoters contribution of 20% of post issue capital for 3 years and the balance of the entire pre issue capital for 1 year from the date of allotment in the public issue.
- (v) The lead merchant banker and the issuer are required to justify the issue price based on the various accounting ratios and they shall not proceed with the issue in case the ratio do not justify the issue price.

14.15 To a query regarding wrong disclosures in the prospectuses, a representative of Midas Touch Investors Association during his personal appearance before the Committee said:-

“Regarding the wrong disclosures in prospectuses, I would like to say that we did a study of a lot of draft prospectuses and found that there were glaring mistakes. We wrote to the SEBI before the public issues came up. They had been given huge amounts of loans by public financial institutions. We pointed it out but nothing was done. Some of them did not go into public issue because the market turned bad but financial institutions gave loans, in some cases up to Rs.100 crore.”

14.16 Enquired whether he appreciated the method of fixing price through book building method, the representative of the Midas Touch Investors Association Said:-

“Not at all. It is totally detrimental”. In the Book building mechanism, etc. we are excluding the small investors an opportunity to participate in it.”

### **Preferential allotment**

14.17 According to Midas Touch Investors Association the present rules as stand framed for “Preferential Allotment” of shares are inherently anti-investor since it erodes his wealth and is a powerful tool, with a few exceptions, for the entrenched managements to manipulate market price of shares.

14.18 Explaining the scope for manipulation on account of preferential allotment, the Association has stated that normally a portion of shares owned by promoter group is under lock-in *i.e.* that they cannot be sold for a certain period. For manipulation of their share prices, promoters require a lot of money. They, normally, raise a substantial part of it, through pledging of their holdings. Preferential allotment of shares when made, comes in handy for sustaining the manipulation. The shares allotted replenishes his holding sold at a very high price or may even increase the percentage of the promoters holding at a lower price as well as it enables him to pledge the same to raise further money required for manipulation and to release the earlier holdings already pledged. It also enables the promoter to sustain liquidity by giving more shares in the market, helps him raise more money required without jeopardizing his control on the company robbing existing small shareholders and trapping the unsuspecting investor in the secondary market. The Association also stated that hundreds of companies, whose share prices went through the roof in the boom, had availed of this loophole.

14.19 Midas Touch Investors Association has, therefore, suggested banning of Preferential allotment to any class of shareholders with an exception of allotment to foreign technical collaborators with the stipulation that the preferential allotment to them be made on the basis

of market prices with a minimum lock-in-period for the entire allotment made on preferential basis and the existing promoters shall not sell/transfer/pledge their shares for a minimum period which may be specified.

14.20 Reacting to the above suggestion of the Association, the Chairman SEBI stated during evidence (27.6.2002):

“Sir, preferential allotment route has been used in most cases for take over in substantial acquisition for which SEBI had appointed a Committee under the Chairmanship of Justice Bhagwati. This Committee had made a recommendation that this should not form part of the take over code. But we have taken a view based on the recommendation that we had received from the Investors Grievances Forum and many other forums, which I had got approved from the Board on 24th (June 2002) that preferential allotment will be allowed as a part of take over in substantial acquisition. We have taken a view on that. It will be treated as a part of it.”

14.21 SEBI’s takeover code stipulates that no acquirer shall acquire shares or voting rights which entitle such acquirer to exercise fifteen percent or more of the voting rights in a company, unless such acquirer makes a public announcement to acquire shares of such company. Certain type of acquisitions including preferential issue, rights issue, interse-transfer, etc. are specifically exempted from the open offer process.

14.22 SEBI had stated that as per the statistics available for the period 1.4.1997 to 31.3.2002 takeovers via exemption route including through panel have been approximately 77% as per the details given below :-

Category	No. of cases	Offer size
A. Open offer	339 (23%)	7,035.25
B. Exemption route	1076 (72%)	17,515.73
— <i>Preferential</i> 547 cases		
— <i>Interse</i> 488 cases		
— <i>Others</i> 41 cases		
C. Through panel	76 (5%)	-
Total	1491 (100%)	

14.23 SEBI had reconstituted the Take Over Code Committee in June 1998 under the Chairmanship of Justice(Retd.) P.N. Bhagwati, in order to further strengthen and review the Takeover Regulations. The Committee submitted its report on 8/5/2002. Following the report, SEBI has proposed to discontinue automatic exemption for acquisition through preferential allotment.

14.24 Enquired whether the Take Over Committee Chairman during his Chairmanship of the Committee had given legal advice in his private capacity in regard to take over by companies through exemption route, a representative of SEBI stated during evidence :-

“Sir, it is a fact that SEBI has received opinions from the Chairman of the Takeover Committee. But the opinions that were received by us, we for ourselves examined the full facts and then have come to conclusions.”

14.25 It is observed from the post evidence reply furnished by SEBI that out of 12 cases in which the Take Over Committee Chairman had given opinion SEBI had accepted four cases, rejected five and decision still awaited on three cases.

14.26 DCA in a note submitted to the Committee has stated that Section 81 of the Companies Act allows a company to issue capital/shares to any person in any manner, whatsoever, subject to a special resolution being passed by the shareholders. Experience has shown that shareholders' resolutions are easy for management to obtain.

14.27 DCA has further stated that inspections in the current "Scam" seem to indicate that one of the routes used for manipulation of share prices has been the so called preferential allotment of shares. The inspections have brought to light that brokers such as Shankar Sharma, Ketan Parekh, Harish Biyani, D.K. Singhanian, etc. received preferential allotment of shares from companies such as HFCL, Aftel Infosys and DSQ Software etc. DCA is considering framing rules under Section 81 read with Section 642 of the Companies Act to govern preferential allotment of shares. DCA has proposed to do this in consultation with SEBI which has issued regulations for preferential allotment. Some of the ideas which have come up in this regard are as follows :

- (i) Preferential allotment of shares cannot be made to a company, if one of its (allottee's) objectives is to trade in shares/securities, or to any individual or firm, which deals with or trades in shares and securities.
- (ii) There should be a lock-in-period of, say, about 18 months.
- (iii) Preferential allotment should be made only against receipt of full consideration.
- (iv) Preferential allotment should be linked to a fair valuation of the share.
- (v) Preferential allotment should be limited to a percentage of the existing paid-up capital, say about 10%.

14.28 Pointing out that investors have lost confidence due to the happenings in the last decade in the stock market, a representative of Midas Touch Investors Association cited the case of vanishing companies and said :

"In the years immediately after liberalization, 1.5 crore new investors, small investors as we call them, came into the market between 1992 and 1996 through IPOs. They were duped. At that time Rs. 86,000 crore were raised in four years through public issues and right issues by four thousand odd companies. Most of these 1.5 crore investors who came in for the first time in the stock market were duped..... Till date 229 companies (only) have been identified by the Government appointed monitoring committee, as having made public issues and disappeared. No one has been arrested and no money has been recovered. There has not been even an action plan as to how to recover that money."

14.29 With a view to restoring investor confidence, the Midas Touch Investors Association made the following suggestions:

(a) *Manipulation of share prices to be made a cognizable offence:—*

*"Insider Trading" "Price-Rigging" and manipulation of share prices through "fraudulent and unfair trade practices" be made a cognizable offence under the SEBI Act and SEBI be authorized and made responsible for filing of F.I.Rs in all such cases.*

(b) Promoters to disclose their intent to increase or decrease their shareholding:-

The disclosure should contain information regarding reasons and object of the proposed change in the promoters holding, source of funding in case fresh purchases are proposed, their present holdings, lock-in period details, quantities pledged etc.

(c) To define "Undesirable activities" in the SEBI Act :-

To empower SEBI to declare such persons/entities found to be involved in "Undesirable activities" as "Undesirable" and prohibit them from holding office of director or trustee or in any fiduciary capacity for at least five years or till they have compensated the investors for the losses suffered due to their action/inaction, whichever is later. Definition of "Undesirable activities" be provided in the SEBI Act and SC(R) Act and may include activities like insider trading, price rigging, manipulation of market price of shares, fraudulent and unfair trade practices, directors and promoters of Vanishing companies, failure to make continuing disclosures of price sensitive information timely, non-payment of listing fees or failure to submit important information to the stock exchanges forcing them to suspend trading of its securities which adversely affects the interest of the existing small shareholders.

(d) Investors' Charter :-

For efficient administration of the existing system, imparting it transparency and accountability an "INVESTORS CHARTER" be made by all the regulators, viz. SEBI, DCA and RBI under the respective laws they administer. DCA has made a "Citizens Charter" somewhat on these lines. This would create awareness amongst the investors regarding their rights and obligations. The said Charter may include :

- Delineation of functions and responsibilities of each official whom the investor should contact for redressal of his grievance or administration of a particular provision of law, the time limit for redressal/action and in case of the failure to resolve the same.
- The method by which the individual official and/or concerned department/cell/directors be held accountable and action against the erring person and financial penalties laid down in the respective acts.

(e) Monetary penalties to be twice the amount of unlawful gains made by manipulators or losses suffered by investors whichever is higher.

(f) Mechanism for seizure of assets and disgorgement of unlawful gains.

(g) Representation to investors on Board of Companies, SEBI etc. :-

The small investors should be adequately represented on the—Board of Directors of listed companies through election amongst themselves and through representatives of investors association on the Board of SEBI and Stock Exchanges as well as on the Committee constituted for administration of Investor Education Protection Fund etc.

(h) Representation to Investors on various Advisory Committees :-

The small investors should be given adequate weightage and represented through the investors association in the various advisory committees formed by SEBI, Reserve Bank of India and the Central Government.

(i) A Committee to check end-use of funds raised through Public or Rights issue or misutilisation of funds :-

To constitute a Committee (like Task Forces constituted for Vanishing Companies) under the SEBI Act which shall be responsible and empowered to examine the

*end-use of funds raised by the companies through Public or Rights issue or through any method. If deemed necessary in investor interest, it may further inquire into misutilisation/diversion/siphoning of funds by listed companies.*

(j) *Awarding compensation for the services rendered :-*

*Provision for awarding compensation, by SEBI to the individuals/NGOs, may be incorporated in the SEBI Act, for successful complaints lodged and pursued by them or on sensitive information supplied regarding the securities market operation. This may be modeled on the lines of the provisions of Securities and Exchange Commission of USA.*

(k) *Awarding compensation to successful litigation :-*

*Adequate compensation to be paid, by the regulator, on successful completion of the case or an understanding between the concerned parties, to the investors association which brings matters of investors interest to light, pursue them through Writ Petition/PIL.*

14.30 Tamil Nadu Investors' Association has also made similar suggestions.

14.31 In order to protect the investors' interest, Dr. Mitra has stressed that it is necessary to rescue and preserve fund raised from investors. To achieve this objective his recommendations include the following :

- (a) *Empowerment of the authority (SEBI or DCA) to enquire, search, seize and attach properties acquired out of the public fund and available funds and place the matter before the appropriate court for direction to confiscate and distribute the funds amongst the investors;*
- (b) *Paying of the compensation out of the available sources to the investors by the authorities at the instance of the consumer court/security tribunal;*
- (c) *Authorities' right to dispose the properties through public auction on the direction of the consumer court/security tribunal;*
- (d) *Promoters personal liabilities to compensate the investors;*
- (e) *Attachment of the personal properties of the promoters by the authorities at the instance of the consumer court/security tribunal;*
- (f) *Past directors of issuer company shall be personally liable for all funds diverted without authorisation during their tenure;*
- (g) *Authority shall have power to restrain any public issue or not allow a public issue, which is not in the interest of the investors;*
- (h) *Authority shall have power to debar promoter/director from accessing the capital market or and holding the position of a promoter or director in any company until the issue of the interest of the investors being protected and settled;*
- (i) *There has to be a co-ordination Committee of all the authorities holding the responsibility of permitting any person to have access to the public fund specially for the purpose of protecting the investors' interest;*
- (j) *SEBI should be the only regulator for entire capital market so that it performs its functions well and protect the market from foul play and investors' interest remain secured.*

SEBI in 1998 had forwarded to the Government the proposals for the purpose of amending the Securities laws to award compensation, enhanced monetary penalty etc.

## **(ii) Stock Exchanges**

14.32 Investors' Protection Fund has been set up in all Stock Exchanges as per Ministry of Finance instruction dated 22.8.1985. The total corpus of Investor Protection Fund of 21 exchanges is Rs. 222.5 crore as on 31.3.2001. The purpose of the fund is to provide compensation, arising out of defaults of the member brokers of the exchange, to investors. The amount of compensation available against a single claim of an investor arising out of default by a member broker of a stock exchange is Rs.1 lakh in case of major stock exchanges, Rs. 50,000 in case of Medium stock exchanges and Rs.25,000/- in case of smaller stock exchanges. However NSE provided a compensation of Rs. 5 lakhs in 2001 which has been enhanced subsequently to Rs. 10 lakhs and BSE provides compensation upto Rs.10 lakhs from this fund.

## **D. Investors Education**

14.33 According to a representative of Tamil Nadu Investors Association investors education programme is totally absent and SEBI or DCA have not done much on the education of investors. The representative also pleaded that investor associations should be formed all over India because NGO-type of operation only can do this kind of educational activity and also have more of awareness programmes. He further stated that we must have a proper methodology of forming investor associations probably in each district headquarters and state-wise and regulators like SEBI and DCA can make use of these associations for investor education movement.

### **(i) SEBI**

14.34 SEBI has stated that it has taken various steps including the following for educating the investors:-

- (i) Issuing of series of advertisements in various newspapers. This advertisement educating the investors, *inter-alia*, about their rights, responsibilities and key terms used in Capital Market was issued in various editions of 13 national newspapers in Hindi and English.
- (ii) Printing and circulating copies of a booklet titled "A Quick Reference Guide for Investors" through corporate entities. It is estimated that so far, over 1 crore of these booklets have been circulated through various companies.
- (iii) Registration of 11 Investors' Associations under a stipulated eligibility criteria. The Investors' Associations registered with SEBI are eligible to draw, as a one time measure, a sum of Rs. 1 lakh Per Association for setting up computer terminals, installation of database on companies and internet connectivity. The registered investors' associations are also eligible to draw a sum of Rs. 5 lakh per association for organizing seminars related to securities market for Investors Education, publication and circulation of investor education material subject to a limit of Rs. 50,000/- per seminar.
- (iv) SEBI has been issuing extensive press releases/public notices from time to time to educate and caution the investors about risks associated with investments in Collective Investment Schemes. Members of public have been, *inter alia*, cautioned through these public notices that they should not invest in the CIS entities which are not registered with SEBI.
- (v) SEBI has broadcast educative message for the investors in Collective Investment Schemes through National Hook up and regional stations of Vividh Bharti.
- (vi) SEBI has also issued message in the interest of investors on National Channel and Regional Stations on Doordarshan with regard to Collective Investment Schemes.

14.35 SEBI has also stated that it has been encouraging the Investors' Associations registered with it for organizing seminars for Investor Education in capital market, in various cities and has been providing financial support to them in this regard. The investors' Associations have organized about 20 Investors Education Seminars during the last one year.

#### **(ii) Department of Company Affairs**

14.36 In the Department of Company Affairs a fund called the 'Investor Education and Protection Fund', has been established under section 205 C inserted in the Companies (Amendment) Act, 1999. The fund is credited with such amounts as remained unclaimed and unpaid for a period of seven years in relation to dividend, application moneys, deposits with companies, etc. The Fund shall be utilized for promotion of investors awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

14.37 Regarding the corpus of the fund a representative of the Department of Company Affairs said that since this was the first year that DCA would be spending this money, the Ministry of Finance told them that let DCA start their activities and when it picks up its activities they could approach the Ministry of Finance for extra allocation. He also informed that the Department has framed guidelines for the purpose of financial assistance from the Fund.

14.38 Dr. Mitra in his report has pointed out that since SEBI has been constituted especially to protect the interest of the investors, the above Fund should be administered by SEBI and has recommended that Section 205 C of the Companies Act be repealed and the same provision be included in the SEBI Act.

#### **(iii) Stock Exchanges**

##### **NSE**

14.39 NSE has put in place systems to ensure that proper, up-to-date and correct information is available to the investors to enable them to take informed decisions and to ensure that their interests are protected. NSE ensures that critical and price-sensitive information is available to all classes of investors at the same point of time. Such price-sensitive information as, bonus announcements, mergers, new line of business, etc. received from the companies is disseminated to all the market participants through the network of NSE terminals all over India.

14.40 Regarding investor education, a representative of NSE stated during evidence:

"We try and spend a lot of energy in investor education because we feel that it is very difficult to eliminate fraud completely from any system. One is that when we built the NSE trading system, we put in all kinds of things for transparency like a contract note must mention complete orders, trade details, time stamp etc. and there will be a complete audit trail kept in the exchange and if any investor has a doubt that his broker may be cheating him, he may call up the exchange or write a letter. We will give him the complete details of his transaction. Second, we felt that we must tell the investor what his rights and responsibilities are. In the last 18 months, we must have done 80 or 90 such investor protection programmes all over the country, some in different languages as well, where we have tried to teach or educate the investor as to how he must protect himself."

14.41 As regards investor protection measures, NSE has suggested that training of investor associations personnel may also be undertaken so as to be able to strengthen handling of investor grievances. A compendium of common pitfalls and mistakes which lead to investor losses may also be printed and distributed widely in regional languages.

## BSE

14.42 BSE conducts Investor Awareness programmes regularly covering topics such as Investors' Protection Fund, Trade Guarantee Fund, Dematerialisation of shares, information on Debt Market, Investor Grievance Redressal system available with SEBI, BSE and Company Law Board, Information on Sensex and other indices, etc. BSE has earmarked Rs. 1 crore for assistance to Investor Associations for conducting Investor Awareness and education seminars etc. During the year 2000-2001 Rs. 20 lakh has been disbursed to SEBI-recognized Investors Associations. BSE's Training Institute organizes Investor Education programmes periodically and more than 10,000 Investors have reportedly been trained through various courses. BSE's official website disseminates and updates Investors with the latest information on Stock Markets. BSE also submitted that it regularly comes out with publications for Investor education on various products and processes.

## CSE

14.43 Calcutta Stock Exchange has submitted to the Committee that it has been conducting a training programme for members of the public free of cost since more than two decades. This imparts training to persons in the fundamentals of operations of the stock market. This apart CSE has opened a few investor service centers in places to provide the adequate pre-requisite knowledge and technical support to the investors.

## E. Redressal of Investor grievances

### (i) SEBI

14.44 SEBI has established a comprehensive investor grievances redressal mechanism. The Investor Grievances Redressal and Guidance Division of SEBI assists investors who prefer to make complaints to SEBI against listed companies. Each complaint received by SEBI from the investors is acknowledged and a reference number is sent to the complainant. Each complaint is taken up with the company and if the complaint is not resolved within a reasonable time, a periodical follow up is also made with the company. SEBI officers also hold meetings with the company officials to impress upon them their obligation to redress the grievances of investors. Errant companies are warned of stern action for their failure to redress grievances. Recalcitrant companies are referred for prosecution.

14.45 SEBI in its annual report 2000-01 has presented the cumulative status of investors grievances received by SEBI, those resolved by companies and the redressal rate in this regard during the last ten years as reproduced below:-

Financial Year and (March)	Grievances Received (cumulative)	Grievances Resolved (cumulative)	Redressal Rate
1	2	3	4
1991-92	18,794	4,061	21.61
1992-93	1,29,111	27,007	20.92
1993-94	7,13,773	3,66,524	51.35
1994-95	12,29,853	7,18,366	58.41
1995-96	16,06,331	10,34,018	64.37

1	2	3	4
1996-97	18,23,725	14,65,883	80.38
1997-98	23,35,232	21,42,438	91.74
1998-99	24,34,364	22,69,665	93.24
1999-2000	25,32,969	24,16,218	95.39
2000-2001	26,29,882	25,01,801	95.13

It may be observed from above that redressal rate of grievances is over 90% during the last four years. SEBI has, however, not disclosed the age-wise pendency of complaints.

14.46 In order to ascertain correct status of redressal of grievances where companies did not report back, SEBI has been conducting an exercise of sending reply paid post cards to investors requesting them to reply as to whether their complaint has been resolved by companies or not. Year wise data in this regard have been compiled from three annual reports of SEBI pertaining to the year 1998-99 to 2000-01. Post cards are sent only to those investors by SEBI where the complaints are shown as pending in records of SEBI i.e. where the companies have not reported redressal of those cases, when SEBI wrote to investors by sending post cards, they reported redressal of their complaints which presents a disappointing picture as shown below:

Year	Post cards sent	Replies indicating complaints not resolved	Percentage not resolved
1998-99	75,496 <sup>a</sup>	33,356	44.18
1999-2000	78,239 <sup>b</sup>	45,044	57.57
2000-01	69,131 <sup>c</sup>	40,629	58.77

(a) Complaints pending as of 3.3.1998.

(b) Grievances pending as of 31.3.1999.

(c) Grievances received upto 31.12.99 and pending as on 30/4/2000.

It may be observed from above that the redressal rate was around 56% in 1998-99, 42.5% in 1999-2000 and 41.23% in 2000-01. This redressal rate is for those complaints where the companies did not report redressal earlier.

14.47 The data regarding age-wise pendency of complaints would give an indication of the effectiveness of grievances redressal machinery. This information is, however, not available in the SEBI's Annual Report.

## (ii) Department of Company Affairs

14.48 The Department of Company Affairs has also set up an Investors Protection Cell. Investor complaints received in this Cell are processed for action by referring them to the concerned companies for speedy redressal. An acknowledgment is issued and subsequently, action taken as informed by the company is also communicated to the complainant. The Department has reportedly processed 7834 complaints during the period from 1.4.2000 to 31.12.2000 out of which, 7343 complaints were satisfactorily redressed. During the period 1.4.2000 to 31.12.2000, prosecution against 90 companies were ordered by Investors Protection Cell.

### (iii) Stock Exchanges

14.49 The data regarding receipt and disposal of investor grievances in respect of last three years as presented by BSE and as observed from the fact book of NSE are shown below:-

#### Complaints against Members.

Year	BSE				NSE			
	B/F	Received	Resolved	Pending	B/F	Received	Resolved	Pending
1998-99	52	465	472	45	111	383	347	147
1999-2000	45	348	343	50	147	197	298	46
2000-01	50	779	417	412	46	263	201	108

#### Complaints against Companies

Year	BSE				NSE			
	B/F	Received	Resolved	Pending	B/F	Received	Resolved	Pending
1998-99	20775	43727	54579	9923	197	592	380	409
1999-2000	9923	30040	33065	6898	409	808	842	375
2000-01	6898	37461	28948	15411	375	1095	1111	359

#### Arbitration Matters

Year	BSE Client v/s. Member				Year	NSE			
	B/F	Received	Resolved	Pending		Received	Withdrawn	Awards	Pending
1998-99	233	289	374	48	1999	155	5	144	6
1999-2000	148	298	359	87	2000	150	4	104	42
2000-01	87	231	270	48	2001	60	3	2	55

14.50 There have also been cases where the investors have introduced fake/forged/stolen shares resulting in loss to the member brokers. Further several investors do not rectify bad deliveries and do not pass the corporate benefits resulting in loss to member brokers. In BSE, there were 65 arbitration cases out of 298 cases in the year 1999-2000 and 111 cases out of 231 in the year 2000-01 pertaining to non payment of dues by investors or non-delivery of shares by investors to the brokers.

### F. Insurance Coverage to small investors

14.51 It is observed from the information furnished by RBI that Deposit Insurance and Credit Guarantee Corporation (DICGC) is a wholly owned subsidiary of RBI. All eligible cooperative banks are required to be registered by DICGC as insured banks. The deposits of those banks remain covered under Deposit Insurances. The depositors in a non-banking financial company (NBFC), however does not come within the ambit of DICGC. It is learnt that for years small investors and Investors Associations have been demanding insurance coverage upto Rs. 1 lakh to the depositors in NBFCs, also.

14.52 Investor protection is a continuous exercise and not a one-time effort. A recent survey done by National Council of Applied Economic Research for SEBI reveals that only a nominal portion of household savings flow into the capital market. The main reason for such insignificant flow can be attributed to lack of confidence of the retail investors in the capital market. It has been observed that poor disclosures at the time of public issue and manipulative pricing of the 'issues' by the companies often results in robbing the uninformed investor. In order, therefore, to ensure that the investors are well informed, it is not only very important to have full disclosures but also to ensure that these are authentic. The Committee recommend that the Managing Director/Chief Executive Officer and one Director of the Company at least, must certify all disclosures made by the listed companies to be true and correct and in case the same are found to be false, these officials must attract criminal liability under the law.

14.53 The Committee are also given to understand that the prospectus is not vetted by SEBI, with the result that promoters are able to bring public issues at highly manipulative prices. It is therefore imperative that SEBI should formulate suitable guidelines for evaluating the prospectus and in case of dubious or fraudulent promoters, it must stop the public issue. As regards IPOs (Initial Public Offering), two vital issues-pricing and tracking the end use of funds have been totally neglected by SEBI. While determining pricing is a difficult task, there can be differences of opinion about the price genuinely, but to leave this entirely to the discretion of management based on the recommendations of the merchant bankers, does not serve the interests of small investors. The very fact that during the mid-nineties, in many cases, dishonest management of the companies cheated the poor investors of thousands of crores by bringing out highly overpriced issues and SEBI did not react, on the plea that in the free market regulator need not interfere, is not acceptable to the Committee. Totally free market pricing in a market which is highly imperfect and has a long history of fraud and manipulation is not a workable solution. Fair pricing through the book building rules has also failed to achieve the desired results. It is, therefore, suggested that SEBI should either use industry benchmarks or evolve other suitable criteria for this purpose. SEBI and DCA have been quibbling for the past many years, each one saying that to determine the end use of the funds raised through IPO was not its responsibility, with the result that manipulative promoters have had full liberty in diverting the funds. The Committee are of the view that this responsibility must be discharged by SEBI and the management of defaulting companies should be suitably punished.

14.54 The Committee feel that award of compensation to aggrieved investors is an area which requires urgent attention. The Committee in this connection note that Dr.N.L. Mitra in his study on investors' protection has suggested that Consumers' Court or Securities Tribunal should be empowered to award compensation to aggrieved investors. He has also suggested a separate Act for protecting investors' interest. The Committee feel that implementation of these suggestions will go a long way in protecting the investors' interest and accordingly recommend expeditious consideration of these suggestions for implementation.

14.55 An Investors Association has made a plea for banning preferential allotment of shares, except for foreign collaboration, on the ground of being inherently anti-investor and being a powerful tool to manipulate market prices of shares. The Committee note that SEBI has since decided to bring preferential allotment of shares under the take-over code and will subject it to stringent discipline. This step should not eliminate preferential allotment of shares to legitimate purposes like giving equity stake to a technical collaborator but should be strictly watched to prevent misuse. The Committee hope that the Department of Company Affairs, as proposed, would expeditiously frame rules governing preferential allotment of shares under Section 81 of the Companies Act in consultation with SEBI.

14.56 It transpired during evidence that the Chairman of the Take over Committee appointed by SEBI, during his Chairmanship, had given legal advice in his private capacity in regard to take over by companies. Such acts appear inappropriate.

14.57 A number of suggestions has been made to protect the investor's interest and to restore the confidence of investors in the stock market as contained in paragraphs 14.29 and 14.31. Some of these have been recommended in this report under the Section "Powers of SEBI" which include the suggestions regarding power of investigation, power to impound/retain documents, attachment of the properties of defaulting Promoters/Directors/Companies, enhancement of monetary penalty, power to disgorge ill-gotten profits and power to impound ill-gotten money. The Committee particularly agree with the suggestions viz., distribution of impounded funds amongst the affected investors, making manipulation of shares a cognizable offence, mandatory disclosure by promoters of their intention to increase or decrease their share holdings and the need to define "undesirable activities" and accordingly recommend that appropriate action be taken in this regard. The Committee is inclined to agree to giving representation to investors on Boards of listed companies, on SEBI, and on various Advisory Committees, and recommend that this aspect be examined for suitable action. The Committee hope that suggestions for encouragement and suitable funding of investors associations will receive consideration in order to ensure their active participation in matters relating to investors protection.

14.58 Investor education plays a vital role in enabling investors to take informed decisions and to ensure that their interests are protected. It appears that not much has been done in this area by SEBI except issuing some advertisements, circulation of a booklet and funding of seminars by Investor Associations. At present SEBI, DCA and RBI have their parallel independent investor awareness campaigns. The Committee feel that coordinated and organized efforts are needed to educate investors about their rights and responsibilities and to impart awareness about common pitfalls and mistakes that lead to investor losses and SEBI should be vested with this responsibility. Further, the Committee feel that to enable SEBI to undertake this task effectively, the Investor Education and Protection Fund established under Section 205 (c) of the Companies Act and Investors Education Resources of RBI should be shifted to SEBI and a joint campaign under the leadership of SEBI be undertaken. The Committee also recommend that unclaimed/undistributed funds such as dividend, principal amount, interest, debenture amount and fixed deposits of any nature and instrument with limited companies, cooperative banks, banks mutual funds and insurance companies should be transferred to this Investor Education and Protection Fund.

14.59 The other important issue, which has been neglected by SEBI, pertains to resolution of investor complaints, whether against companies or other stock market intermediaries. Though the cumulative redressal rate of investor grievances against companies presented in SEBI's annual report has been above 90% during the last four years, the feed back received by SEBI from the investors indicates a redressal rate of just 41 to 43 per cent in the years 1999-2000 and 2000-01. Liquidity is the essence of capital market and delay in redressal of the investor complaints militates against the liquidity. The Committee suggest that SEBI should examine the reasons for sluggishness in resolving investor complaints and must ensure that all investor complaints against the companies are resolved within 30 days. Failure in this regard requires to be punished with heavy financial penalties which both the Stock Exchanges and SEBI must be empowered to impose. Further, along with the public disclosure of quarterly financial results, companies must be directed to publish the number of investor complaints received, disposed off and lying unresolved at the end of each quarter. Such public disclosure will go a long way in pressurizing the companies to act with speed.

14.60 There also appears to be a need to have an independent look at resolution of investor complaints against companies and market intermediaries. The Committee recommend that the concept of Ombudsman, which is already being used in the banking sector, should also be extended to the capital market. The issue of power, duties and responsibilities of the Ombudsman should be suitably worked out. As regards investor complaints against Brokers and other market

intermediaries, arbitration councils at exchange level can be used for resolution of investor complaints. Such bodies would be independent of market intermediaries, particularly the brokers. The Committee are of the opinion that ultimately Special Courts dealing exclusively with the investor complaints of the financial sector would be a real solution to the expeditious disposal of complaints. Such courts could have jurisdiction for all kinds of financial irregularities, frauds in the case of the capital market, chit funds, NBFCs, plantation companies. Etc.

14.61 The Committee also recommend that a Committee consisting of representatives of SEBI, DCA, RBI (NBFC and Banking Division), Stock Exchanges, Investors Associations should be set up to develop an effective investor grievances redressal system.

14.62 SEBI need to act as the nodal agency to receive complaints of investors, transmit them to agencies concerned and follow them up for speedy action. An independent audit on redressal of investors' complaints by the regulators should be conducted periodically.

14.63 The Committee learn that compensation payable from the Stock Exchange Investors' Protection Fund on account of defaults of brokers involve several months or even years to resolve although it is required to be resolved within 90 days. The Committee feel that the operation of the Investors' Protection Fund in Stock Exchanges needs to be streamlined.

14.64 The Committee note that at present insurance coverage from the Deposit Insurance and Credit Guarantee Corporation (DICGC) is available to depositors in Co-operative Banks. The Committee suggest that the feasibility of extending a similar scheme to depositors in NBFCs may be examined. The amount of insurance coverage which stands at Rs. 1 lakh at present also needs to be raised at least to the level of Rs. 2 lakh.

14.65 A scrutiny of complaints handled by the Stock Exchanges viz., BSE and NSE reveals that the number of complaints against companies has been very much higher than against members of the exchanges. For instance, in the year 2000-01, complaints received by BSE against companies stood at 37,461 and those against members at 779. In NSE, the corresponding figures were 1,095 and 263. The same is true of the previous years. The Committee suggest that companies including "Z" category companies of BSE, which are deficient in their services to investors should be identified and strict action taken against them. Companies that deliberately ignore investor complaints need to be severely punished. The Committee recommend that legislative lacunae, if any, in implementing these suggestions should be removed.

**PART-II**  
**UNIT TRUST OF INDIA**

**CHAPTER XV**

**OVERVIEW**

15.1 The Unit Trust of India is a statutory corporation established by Parliament through the Unit Trust of India (UTI) Act, 1963 which came into force on 1.2.1964. The Preamble to the Act states:

“An Act to provide for the establishment of a Corporation with a view to encouraging saving and investment and participation in the income, profits and gains accruing to the Corporation from the acquisition, holding, management and disposal of securities.”

While introducing the Unit Trust of India Bill in the Lok Sabha on 4/12/1963, the then Minister of Finance stated,

“...this institution as we see it, is intended to cater mainly to the needs of the individual investors, and even among them, as far as possible, to those whose means are small.”

15.2 The initial capital of UTI was Rs. 5 crores which was contributed by the following institutions:

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(a) Reserve Bank of India (RBI)	Rs. 2.50 crores
(b) Life Insurance Corporation of India (LIC)	Rs. 0.75 crores
(c) State Bank of India (SBI) and its subsidiary banks	Rs. 0.75 crores
(d) Scheduled banks (other than SBI and its subsidiary banks) and notified financial institutions	Rs. 1.00 crore
	<hr/> Rs. 5.00 crores

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15.3 In 1975, the UTI Act was amended so that the Industrial Development Bank of India (IDBI) took over the rights and responsibilities of RBI. RBI's share of the initial capital was also transferred to IDBI. Under Section 9(1) of the Act, the management of the UTI vests in a Board of Trustees. As per Section 9(2), the Board of Trustees is supposed to discharge its function “..... on business principles regard being had to the interests of the unit holders.” The Board of Trustees comprises:

- (a) The Chairman to be appointed by the Central Government in consultation with IDBI.
- (b) One trustee to be nominated by RBI.
- (c) Four trustees to be nominated by IDBI of whom not less than three shall be persons having special knowledge of, or experience in commerce, industry, banking, finance or investment.

- (d) One trustee to be nominated by LIC.
- (e) One trustee to be nominated by SBI.
- (f) Two trustees to be elected by other contributing institutions viz. scheduled banks (other than SBI and its subsidiary banks) and notified financial institutions.
- (g) An executive trustee to be appointed by IDBI, provided that such an appointment may not be necessary if the Chairman is whole time.

Under the UTI Act the Board has to meet not less than six times a year and at least once every two months. The Act also provides for an Executive Committee (EC), which, subject to general or special directions from the Board, has the power to deal with any matter within the competence of UTI. The EC consists of the Chairman of the Board, the Executive Trustee and two other trustees nominated by IDBI. According to UTI the EC normally meets once every month. The day-to-day operations of UTI are looked after by a full time Chairman assisted by a team of Executive Directors and Chief General Managers. The financial year of UTI is from July to June and a copy of its balance sheet, accounts and auditors report is published annually.

15.4 Section 19 of the Act, which defines the business of the Trust, originally limited UTI's activities to selling and purchasing units, transacting in securities and formulating unit linked savings, life insurance and other plans. It was amended with effect from 1986 to greatly widen the scope of the Trust's business to include activities like granting of loans and advances, dealing in bills of exchange, investing in Central government, foreign government and other securities, dealing in and developing immovable properties, leasing and hire purchase finance, merchant banking and investment advisory services, rendering investment or fund or portfolio management services abroad, opening accounts and making agency arrangements with foreign banks, transacting in foreign exchange and any other business connected with mobilization of savings or investments authorised by the Central Government. This amendment gave UTI a hybrid character as it can indulge in lending activities like term loans and leasing, besides transacting in securities.

15.5 From 1964 to 1986, UTI was the only institution offering mutual fund products and it experienced consistent growth. After 1986, competition to the UTI emerged in the form of mutual funds launched by the subsidiaries of the nationalized banks and the insurance corporations viz. LIC and General Insurance Corporation (GIC). After 1992, private sector mutual funds including those with foreign sponsors entered the market and the Securities Exchange Board of India (SEBI) also instituted a regulatory regime for mutual funds. During this period UTI, though still the largest mutual fund in the country has lost market share in terms of assets under management as shown in **Appendix—XII**.

15.6 The circumstances under which the Committee are looking into the affairs of Unit Trust of India have been mentioned in Chapter I, Part I of this Report. Specifically the mandate of this Committee is to look at "...all issues relating to UTI including the issues discussed in the House."

15.7 In the light of debates held in the Rajya Sabha on 24.07.2001, 25.07.2001, 30.07.2001, 31.07.2001, 1.08.2001, 2.08.2001 as well as the debate in the Lok Sabha on 2.08.2001 the issues relating to UTI have been examined in detail in the subsequent chapters under the following Chapter headings:

- Chapter XVI — Investment Policy and Decisions
- Chapter XVII — Unit Scheme-64

Chapter XVIII	—	Role in Calcutta Stock Exchange Payout Crisis
Chapter XIX	—	Role of Trustees
Chapter XX	—	Ministry of Finance and UTI
Chapter XXI	—	Future Role

15.8 In preparing the report on the Unit Trust of India, the Committee have had the benefit of going into the following reports of different Committees set-up by the Government or the Unit Trust of India:

- (a) Report of the Committee on Review of Regulatory Framework (chaired by Shri N. Vaghul) submitted in September 1993,
- (b) Report of the Deepak Parekh Committee on US-64 submitted in February 1999,
- (c) Report of the Corporate Positioning Committee (chaired by Shri Y. H. Malegam) submitted in October 2001, and
- (d) Report of the High Level Committee to inquire into the Activities of the Unit Trust of India (chaired by Shri S.S. Tarapore) also submitted in October 2001.

In arriving at their conclusions, the Committee have taken into account the findings and recommendations of the reports mentioned above, particularly the report of the Tarapore Committee. In addition, the Committee had the benefit of briefing and evidence lasting 40 hours 55 mts. in which the following witnesses were examined:

- (i) Representatives of Unit Trust of India
- (ii) Former Chairman, UTI, Shri P.S. Subramanyam
- (iii) Representatives of Industrial Development Bank of India
- (iv) Representatives of ICICI
- (v) Representatives of RBI
- (vi) Shri S.S. Tarapore, Former Deputy Governor, RBI
- (vii) Dr. E.A.S. Sarma, Former Secretary, Department of Economic Affairs, Ministry of Finance.

**15.9 It is the view of the Committee, as detailed in the subsequent chapters, that the crisis faced by UTI reflects the decline of a public institution on account of its failure to change itself to face competition and regulation since the opening up of the country's financial markets in 1993. The present state of affairs in UTI is a consequence of the negligence of its principal contributor, IDBI (which is also a public sector institution), the concentration of power in the post of the Chairman, UTI without adequate checks and balances to prevent its misuse, and the unwillingness of the UTI management and the government to make the necessary legislative and organizational changes to restructure the institution and bring it under the purview of the market regulator. Moreover, investment decisions in UTI were not always prudent or in accord with the interests of the investors. UTI's competitive environment was constantly changing and 1993 onwards successive governments very well realised that UTI had to be revamped to keep pace with change but did not take effective measures on this front, as they did not wish to lose control over it. A combination of lack of urgency in successive governments, abetted by self serving and negligent management in UTI and inertia in the Ministry of Finance undermined a public financial institution by directing its investment and lending decisions in favour of dubious**

private sector promoters in the name of reviving the capital markets, ignoring the fact that the purpose of UTI was to serve the interest of unit holders, specifically individual unit holders of small means. The UTI episode also focuses the need for improving the system by which statutory institutions can be made more accountable to Parliament and the public to ensure transparency in their functioning.

## CHAPTER XVI

### INVESTMENT POLICY AND DECISIONS

16.1 The general superintendence, direction and management of the affairs and business of the Unit Trust of India are vested in an eleven member Board of Trustees including the Chairman who is appointed by the Central Government in consultation with the Industrial Development Bank of India (IDBI). The UTI Act also provides for an Executive Committee (EC) comprising the Chairman, an Executive Trustee appointed by the IDBI and two other Trustees nominated by the IDBI. The EC can, subject to any general or special directions, deal with any matter within the competence of the Board. The Board is also empowered under the UTI Act to delegate those of its powers and duties under the Act, as it deems necessary, to any officer of the UTI, subject to any conditions and limitations it may set.

16.2 The investments made by the UTI may be classified into:

- (i) Primary market investments;
- (ii) Secondary market transactions; and
- (iii) Other transactions like money market transactions and inter-scheme transfers.

The major classes of UTI schemes are Unit Scheme 64, Pure Equity Schemes, Income/Debt Schemes, Balanced Schemes and Index Schemes. The schemes can also be classified as open-ended schemes and close-ended schemes. A large number of closed-end schemes are assured return schemes.

16.3 The High Level Committee chaired by Sh. S.S. Tarapore, which was set up by the government on 26.7.2001 to inquire into UTI's activities had the following terms of reference:

- (i) To ascertain whether investment/disinvestments decisions taken by UTI and in particular in the US-64 scheme in the last 10 years or so were based on commercial or extraneous considerations.
- (ii) To look into the level at which investment decisions were taken as also the appropriateness and transparency with which these were executed.
- (iii) The reasons, if these were other than commercial, for the high level of dividends declared by the UTI for the US-64 Scheme in the past and the decision to dip into reserves to fund the same.
- (iv) UTI's involvement, if any, in the Calcutta Stock Exchange payout crisis in February-March, 2001; and
- (v) Redemptions of US-64 units in April-May 2001, and if there was any breach of confidentiality.

The Committee have used the data, analysis and conclusions of the Tarapore Committee to ask questions and seek clarifications from various sources to arrive at their findings and

recommendations regarding UTI. The Committee also invited Shri S.S.Tarapore to appear and clarify certain issues arising out of his report. Besides this, IDBI under powers granted to it under section 30 of the UTI Act, directed UTI in May 2001 to get a special audit of its schemes conducted for the 21-month period from 1.7.1999 to 31.3.2001. The executive summary of the two special audit reports is at **Appendix-XIII**.

#### **A. INVESTMENT POLICY**

16.4 The authority to approve investment of funds in any of the UTI's schemes was vested only with the EC, Chairman or Executive Trustee (ET) and there was no delegation of powers to any other functionary. As a practice, the Chairman/ET approved all investments in primary market instruments and were also the only ones authorized to undertake transactions in the secondary and money market. A statement of secondary market orders placed by fund managers during the day (scrip-wise and scheme-wise) was put up to the Chairman for ratification at the end of each day. Similarly, transactions in the money market were also put up to the Chairman for ratification. The Tarapore Committee has stated that,

"Investment and credit rating decisions, as also decisions on inter-scheme allocation of investments are outside the purview of the internal auditors. The statutory auditors the SEBI appointed auditors are not required to comment on the quality and appropriateness of investment/disinvestment decisions. Moreover, investment decisions, once taken, are not subject to *post facto* scrutiny through an instrumentality such as internal audit, to ensure compliance of the laid down norms."

**16.5 The Committee are astonished to find that statutory auditors are not required to comment on the quality of investment decisions and that these decisions are also not subject to any subsequent scrutiny. The Committee urge that this be done forthwith.**

16.6 The General Regulations of the UTI state that the investment of funds by the UTI under any of its schemes should ordinarily not exceed 5 percent of the funds available or 15 percent of the total securities issued and outstanding by such a corporation, whichever is lower. The regulations also restrict the aggregate investments by the Trust in the capital initially issued by new corporations to 5 per cent of the total amount of such funds. Another of UTI's regulations permits the Trust to ".....grant loans and advances (including bridge loans) to, or make advance deposits with, any corporation or a co-operative society registered under the law relating to co-operative societies, primarily engaged in any industrial activity or for such other purpose and on such security as the Board or Executive Committee may decide." These norms contained in regulations 36 and 37 are not in accordance with the SEBI regulations which state that no fund should own more than 10% of any Company's paid up capital carrying voting rights. This was brought to the attention of the UTI by SEBI vide a letter dated 23.6.1994 in which it was suggested that the UTI suitably change the regulations but it was only in the Board of Trustees meeting of 20.12.2001 that an amendment of these regulations to bring them in line with SEBI regulations was approved and forwarded to IDBI for its approval. The Tarapore Committee has also concluded that the UTI had not as yet documented a comprehensive, cohesive and transparent investment policy.

The Board of Trustees of the UTI has, from time to time, delegated financial powers to the EC, Chairman/ET and other officials of the trust. As far back as April 1983, the Board of the UTI used to approve the list of companies and fix limits for purchase/sale of equities, preference shares and debentures in the market. This system was given up at some stage, which is not ascertainable. The Chairman was authorized to approve purchase and sale of equity/preference shares and debentures in companies upto the limits approved by the Board while the authority

for sanctioning private placements of debentures, bridge loans, under-writing commitment, etc., was vested with the Board of Trustees/EC. The Chairman's financial powers were enhanced in September 1992 and he was delegated power to decide primary market investments upto Rs. 10 crore which was further enhanced to Rs. 25 crore in November 1992 while the EC was authorized to consider all other proposals in excess of this amount. The scheme of delegation never clearly stated whether these financial powers were intended only for investments in primary market or could be exercised for investments in secondary market as also by way of private placement of equity/debt/off-market deals, etc. According to the UTI, to keep pace with the changes in the financial sector like the introduction of new debt instruments and the competition from the opening up of the mutual fund industry, the Chairman's powers were revised upward by the Board to Rs. 50 crore in December 1994 along with placing more emphasis on credit rating of instruments.

16.7 The Standing Committee on Finance (1999-2000) in paragraph 4.14 of its 8th Report had opined that:

"...concentration of financial powers for investing huge amounts of funds in securities of different kinds in a single individual may lead to undesirable and unhealthy practices."

It had also recommended that :

"...the upper ceiling of the financial powers of the Chairman which are on the higher side need to be rationalized."

The Standing Committee on Finance also noted that though the Board of Trustees is competent to delegate the Executive Committee the powers to sanction/invest unlimited amount of money yet the entire Board should not be completely divested of its sanctioning responsibility. The committee therefore recommended that the entire Board of Trustees should be invariably involved in decisions pertaining to sanctioning/investing huge amounts of money. Though the views of the Trustees on this recommendation are not available in the minutes of the meetings, in their meeting in March 2001, the Board brought down the upper limit of the Chairman's financial power to Rs. 40 crore. They also constituted a Primary Market Investment Committee of four senior executives to make recommendation to the Chairman for investments within the revised limit. As of June 2001, the EC approved investments between Rs. 40 crore and Rs. 100 crore in primary market instruments and unrated Tier II capital issues of nationalised banks and investments upto Rs. 200 crore in specific institutions, viz., IDBI, ICICI and SBI.

16.8 The Deepak Parekh Committee on US-64 scheme had also recommended that the investment and disinvestment decisions should be decentralized, and

"...made on the basis of recommendations from the concerned research analysts, who should have the authority and responsibility of making their recommendations. The fund manager should have the final authority and responsibility in the decision making process based on his perception of the market, and inputs received from corporate analysts, sector analysts, other experts and brokers."

The management of the UTI reported the implementation of this recommendation to its Board on 2.7.1999 by stating,

"Fund managers vested with authority to recommend range buy/sell decisions. Fund Managers have the freedom to take the final investment/disinvestments decisions based on the requirement of the scheme that they manage. Execution done by dealers within the range."

The Tarapore Committee has however stated that while this conveys the impression that the recommendation has been implemented, the perusal of the scheme of the Delegation of Powers and the subsequent Board notes actually indicate that no such financial powers were vested with the Fund Managers. The Committee's own review (in the next section of this chapter) of inter-scheme transfers and investment decisions clearly indicates that fund managers did not or were not allowed to operate autonomously nor were they taking decisions in the interest of their individual schemes. The Board was further informed that the recommendation that the investment/disinvestments decisions should be based on the research analyst's recommendations had been implemented. It was also reported to the Board that the Equity Research Cell gave weekly recommendations, the analysts were vested with the authority and responsibility of making recommendations, and daily morning meetings were being held between the Analysts and Fund managers before trading began. **The Committee feel that the decentralization process was not fully implemented.**

16.9 During the two-year period July 1998–June 2001, there were investments aggregating Rs. 12,152.31 crore in 378 debt instruments by way of private placement. Of these, the EC sanctioned 103 investments amounting to Rs. 6,470.12 crore; the Chairman sanctioned the remaining 275 proposals, and in the process, exceeded his authority in sanctioning 76 transactions amounting to Rs. 1920.82 crore which were later ratified by EC. These 76 transactions included 43 investments of Rs. 982 crore in unrated instruments of banks/FIs/PSUs/Companies.

16.10 A break up of data relating to sanctions accorded by Board/EC/Chairman for investments by way of IPO and private placements in equities and debt instruments for the period 1998-2001 is given in the following table:

**Number of investment proposals approved at different levels during  
July 1998 to June 2001**

Sl. No.	Type of Investment	Total No. of Investments	Total Amount (Rs. in crore)	No. of approvals accorded by		
				Board	EC	Chairman
1.	IPO	30	356.98	—	1	29
2.	Private Placement of equity	65	1468.66	1	15	49
3.	Private placement in debt	378	12,152.31	—	103	275*

\*Includes 76 investments beyond the authority of the Chairman but subsequently ratified by the EC.

Thus the Chairman sanctioned all the IPOs except one. He also sanctioned over 75 per cent of private placements of equity and over 72 per cent of private placements in debt instruments. In this period the Board has sanctioned only one proposal—a private placement of equity of Rs. 7 crore in UTI Securities Exchange Ltd.

16.11 The powers to write off investments were vested with the Board while the Executive Committee/Chairman approved the write off of receivables. There were no exit norms set for investment in debt instruments. It was only in November 1998 that the Trust constituted a Special

Recovery Group for recovering dues from defaulting companies. The Department of Investment Monitoring conducts half-yearly reviews of asset quality. In their management report for 1999-2000, the statutory auditors have specifically commented,

“...it is observed that the level of NPA’s has come down to 7.57 per cent from 16.21 per cent in the previous year. This has been mainly due to the substantial write-back of interest (Rs. 302.91 crore only in cases of steel industries) and investment provisions (Rs. 138.48 crore only in cases of steel industries) consequent upon restructuring carried out during the period under review and not due to actual receipt of either interest or instalment or principal.”

**16.12 The Committee deplore the extent of discretion vested in the Chairman and the EC in making the levels of investments especially in IPOs and private placements in debt and equities. This was all the more deplorable when such investments were not subject to scrutiny, resulting in complete lack of transparency and accountability. The recommendations of the Standing Committee on Finance that such discretionary powers may lead to undesirable and unhealthy practices coupled with the fact that the Ministry of Finance was aware of the extent of authority and its exercise, should have persuaded the Government to intervene in the affairs of UTI keeping in mind the public interest, especially the interest of the ordinary unit holders whose small investments were thus put in jeopardy.**

The Committee also conclude that the reduction of NPA’s reported by UTI were mostly a result of accounting adjustments rather than the actual recovery of dues. Under the provisions of section 19B of the UTI Act, UTI can apply to a court for attaching the assets or transferring the management of a company, which has defaulted in its repayment to UTI. The Committee note that UTI has not invoked this section even once since 1992 though 92 cases before debt-recovery tribunals and 24 before High Courts for recovery of debts from defaulting companies have been filed under the general provisions as on 30.6.2002. The Committee recommend that UTI should focus on recovering its debts from defaulting companies.

16.13 The Vaghul Committee had recommended in 1993 that the UTI should form one or more Asset Management Companies as its subsidiaries for the management of its mutual funds. SEBI had suggested to the UTI in 1994 that it should prepare a time bound programme for separating its fund management and trust functions. The Deepak Parekh Committee also recommended the creation of a separate Asset Management Company for US-64 scheme. The UTI has not set up Asset Management Companies ostensibly on the ground that the UTI Act did not have any such enabling provision for such a set up. Instead the UTI set up three Asset Management Committees in May 1997 for UTI’s domestic schemes, one each for US-64, equity schemes and income/debt schemes. These Asset Management Committees only had advisory roles confined to reviewing the performance of schemes in marketing, investor servicing, compliance, taxation, accounting policy and fund management. Moreover, according to the Tarapore Committee, these advisory Committees comingled trustee and asset management functions. The UTI also claims to have built-up Chinese walls between various funds to protect their interests, but as the inter-scheme transfers in the recent past show this was actually never effectively implemented.

**16.14 While UTI dragged its feet in implementing necessary organizational changes, the Ministry of Finance should have been proactive in bringing in the required legislative changes and bringing home to UTI through its frequent interaction with UTI the need for a radical overhaul in UTI’s investment policies and decision-making mechanisms. The need for this had been apparent for a decade, especially after the receipt of the 1993 Vaghul Committee report and was further underlined by the Deepak Parekh Committee six years later.**

## B. INTER-SCHEME TRANSFERS

16.15 Huge inter-scheme transfers in the UTI have taken place between different funds. According to the Tarapore Committee the logic for such transfers is the double coincidence of wants (i.e. where one fund of the UTI wishes to buy a certain security while another fund wishes to sell the same security). Inter-scheme transfers based on this principle enable a mutual fund to optimise its market transactions by doing away with transaction costs and in the case of the UTI, adverse price movements as well, because of the large size of its operations. The policy relating to inter-scheme transfers for equity investments was laid down by the UTI's Board of Trustees at its meeting held on December 3, 1990.

"Inter Fund or inter-scheme sales would not be effected except under following circumstances and considerations:

- (i) The transactions are at the market prices, and should be completed within five working days from the date of transaction.
- (ii) No brokerage will be involved.
- (iii) Such sale would normally be effected only to a newly created fund and only in its first year of existence."

Inter-scheme transfers were also allowed for debt instruments.

16.16 The Tarapore Committee examined data relating to inter-scheme transfers of equity investments in the period July 1991 to June 2001 in respect of transfers from/to US-64. These are shown in **Appendix-XIV** while the transactions of US-64 with other select schemes of UTI are set out in **Appendix-XV**. In the ten-year period from July 1991 to June 2001, there were 7437 transactions amounting to Rs. 23,589 crore on account of purchase of equities by US-64 from other schemes and an amount of Rs. 30,401 crore towards sale of equities from US-64 to other schemes. This figure registered an increase from the year 1998-99 onwards. The value of total transactions (buying and selling) by US-64 in the two year period 1.7.1998 to 30.6.2001 amounted to a staggering Rs. 43,334 crore when compared with only Rs.10, 656 crore in the previous seven years. There were several occasions when the transfers from US-64 scheme to other schemes only took place temporarily. For example, during 2000-2001, out of the total 1268 transfers, 441 pairs of transactions (i.e. 882 transfers) involved buy-back of the same quantity of shares of the same company from the same scheme after a short duration ranging between one and thirty days. Specifically, during December, 2000, 230 sale transfers from US-64 scheme involving a total pay-in of Rs. 3333.5 crore were made and the same transactions were reversed in January, 2001 at a total pay-out of Rs. 3447.29 crore which translated into a pay-out of Rs. 113.80 crore by US-64 to the detriment of the scheme.

16.17 There were several occasions when brokers undertook inter-scheme transfers, for which UTI's explanation was:

"...The inter-scheme transfer were effected through internal notes by the fund managers, when the agreed transfer price was the closing price of the previous day's market. However, in case of matching requisitions for buy and sell and also in case of intended inter-scheme transfer received from fund managers during market hours, the inter-scheme transfers used to be done by dealing department by placing buy and sell orders through same broker and same exchange at the prevailing market price. This practice was followed as per the requests of the fund managers on verbal instructions of the higher authorities. The daily order placed statement containing *inter-alia* these transactions used to be put up to then ED (Dealing) and Chairman for ratification..."

16.18 The auditors had observed in their management report for the year 1999-2000 that as on 30.6.2000, 25 schemes had negative liquidity shown as inter-scheme dues and that the negative liquidity in US-64 scheme had continued for a very long period reaching a maximum of Rs. 2000 crore. The negative liquidity of the scheme as on 30.06.2000 was Rs. 150 crore. The statutory auditors management report for the year ended 30.06.1999 had also pointed out negative liquidity (i.e. inter-scheme borrowing) as a result of inter-scheme transfers and that in a number of cases, shares of a particular company were sold in the secondary market for one particular scheme but the sales were later allocated to other schemes as it was found that the selling scheme did not have the required number of shares. The Tarapore Committee has given the following findings regarding inter-scheme transfers:

- (i) While the meeting of double coincidence of wants of various schemes through inter-scheme transfers is legitimate, in the more recent period the character of inter-scheme transfers has changed significantly from the initially conceived scheme by a zooming of transactions which cause concerns about the bonafides of such transactions and raise doubts whether this is a case of window dressing.
- (ii) The quantum jump in the last three years ended June 2001 is particularly worrisome as there are no independent Asset Management Companies to safeguard the interest of investors in particular schemes. It is possible that the mechanism of inter-scheme transfers has been used to shift inter-temporal and inter-scheme profits to one set of unit holders at the cost of another set of unit holders.
- (iii) At times it would appear that the transfer of scrips has been with a view to providing temporary support to one scheme at the cost of investors in another scheme. Again, such transfers could circumvent restriction on holdings in a scheme in excess of prudent limits to investments in a single company.
- (iv) Transfers of scrips have also taken place when the transferee scheme was short of funds leading to creation of negative liquidity.
- (v) Frequent transactions have taken place which tend to obfuscate the operations of individual schemes of the UTI.
- (vi) The services of brokers were utilized for inter-scheme transfers on verbal instructions. This was violative of the UTI's own policy in the matter and SEBI guidelines wherever applicable.

16.19 The former Chairman, Shri P.S. Subramanyam, in whose tenure the quantum jump in inter-scheme transfers took place was asked to explain the steep rise in volumes of transfers. His reply was,

"About 22 schemes have been added during that time..... There were maturing schemes. Some schemes have matured. On the day of maturing of the scheme, the entire portfolio is to be liquidated in one day and that is not possible. So, the procedure, which the mutual funds follow, is either to offer it to the other fund manager..... It is not just arbitrarily done. Each scheme is handled by a different fund manager. Both the fund managers have to agree to this."

It was pointed out to him that during 2000-01, out of the total 1,268 inter-scheme transfers in US-64, 441 pairs of transactions (i.e. 882 transfers) involved the buy-back of the same quantity of shares of the same company from the same schemes after a short duration ranging between 1 and 30 days. His response was,

"The practice is on the basis of the redemption pressure on the scheme which would need to be met. The fund manager would like to hold on to particular scrip. Instead of

buying from the market, he takes back. Effectively, if all these transactions, which are inter-scheme in nature, are put into market—let us assume that for a moment—the market would flare up. That volatility factor which arises in the market gets contained if there is transfer within the organization among the schemes rather than bidding it into the market.... Impact cost is less. The brokerage cost is not there."

16.20 The present Chairman, UTI has on the other hand, conceded that the data points to the fact that inter-scheme transfers have been used to boost incomes of certain schemes. In reply to a specific query regarding whether the individual fund managers had consented to these inter-scheme transfers, UTI has stated that till June 2001, such decisions were taken and ratified by the Chairman and Executive Directors. The Committee also note that the entire profits of the US-64 scheme for the year 2000-2001 were from inter scheme transfers alone (**Appendix-XVI**). Regarding the brokerage paid on these transfers, UTI has stated that since inter scheme transfers of a particular day could be effected only on the next day after the closing prices were known, the then Chairman decided to undertake these transactions at the prevailing market rate, which involved payment of brokerage and these transactions took place during his tenure.

**16.21 The Committee note that the UTI management sanctioned inter-scheme transfers to boost the income and liquidity of some schemes, that these decisions were not taken by individual fund managers but by the Chairman and Executive Directors and that brokerage was paid on these transfers in violation of UTI's own guidelines. The Committee find Sh. Subramanyam's explanations regarding these transactions unacceptable and since these decisions were taken and ratified by him, he must be dealt with in accordance with law. The Committee also recommend that UTI take action against other officials who were party to sanctioning inter-scheme transfers in violation of the policy guidelines regarding inter-scheme transfers laid down by the Board of Trustees.**

### **C. PRIMARY MARKET INVESTMENTS**

16.22 According to the UTI, its primary market investment function was spread across Department of Dealing (formerly Department of Investment), Department of Fund Management (Equity), Department of Fund Management (US-64), Department of Fund Management (Debt), Equity Research Cell (ERC), and Department of Investment Monitoring. In case of primary market instruments, the investment process started with prima facie scrutiny of the case and discussion with the company/arranger. In the case of unrated debt, the proposals were forwarded to the Credit Rating Cell (CRC) to get internal rating of the instrument if found prima facie worthy of investment. This Cell has since been disbanded. In syndicated private placements, investments were mostly restricted to externally rated papers. Acceptable cases were put up to the authorities (Chairman/ EC/ Board of Trustees) for a decision. In case of investments in equity an Equity Research Cell (ERC), which provides inputs on company specific research reports and also provides daily, weekly and monthly recommendations. Equity proposals were forwarded to the Equity Research Cell (ERC) for assessing the attractiveness and fair value of the equity shares offered. In the case of project finance cases, most reliance was placed on the Appraisal Note prepared by the lead institution.

16.23 In its review of investment/disinvestments decisions of the UTI, the Tarapore Committee first attempted an overall statistical analysis of investment decisions in the ten-year period 1991-2001 to examine if this revealed any broad patterns. However, it was able to look in detail only at the period 1998-2001 as the data for the period 1991-98 provided by the UTI was scanty and incomplete. There was therefore no substantive analysis of the UTI's investments prior to 1998 and the analysis concentrated on the period 1998-2001.

16.24 An overview of investments in debt and equities *via* private placements, off-market deals and IPO's for 1998-2001 is given in the table in **Appendix-XVII**. These investments amounted to a total of Rs 17,925 crore during the three-year period. Though investments by way of private placements and off-market deals carry higher degrees of risk, there was no risk-based delegation of financial powers in the UTI for making these investments.

16.25 In the case of investments in debt instruments, the Committee have relied on the Tarapore Committee Report as well their own questioning of UTI and its past and present Chairman. The Tarapore Committee has observed that the sanctity of the sanctioning powers and the laid down processes have, on many occasions not been followed. While conceding that such a departure is sometimes required to enable expeditious decisions in a commercial environment, this raises some concerns. It has identified discrepancies in UTI's investment decision making process like cases where the Chairman exceeded his powers and while these decisions were ratified by the EC soon after, the actual disbursement of funds was after a considerable time, raising questions about the urgency of the decision. The validity of these sanctions was also open-ended which is risky because if there are inordinate delays between ratification and disbursements, any adverse developments in the interregnum cannot be taken care of, leading to an unwise investment. There are also instances in which the Chairman had exceeded his sanctioning powers but the ratification by the EC was inordinately delayed.

16.26 In his appearance before the Committee, the former Chairman, UTI, Shri P.S. Subramanyam stated that disbursement to companies in certain industries were discussed at joint institutional forums with financial institutions like IDBI and ICICI. The procedure in these cases was for the participatory financial institutions like UTI to obtain the relevant sanctions after which the lead financial institution in the consortium would proceed to examine the investment proposal in further detail. In such cases if there were any subsequent conditions suggested by the lead institution before the disbursement of funds, these would get incorporated in the details placed before the EC. In some of these cases, there were subsequent restructuring exercises for ongoing projects of the borrower in which additional sanctions were made but there were no cash disbursements since the amounts were to be adjusted against the borrowers previous interest liabilities, thus raising the borrowers liability to UTI without there being any actual cash outgo. There were also cases of private placement of debt by companies in which the debt ratings were of a highly secure grade so most financial institutions were seeking to invest in them. The procedure followed by the Chairman in such cases was to sanction the investment so that a firm allocation was received and put up subsequently to the EC for ratification. As per the subsequent details submitted by UTI, most of these investment decisions relate to consortium lending.

16.27 Other discrepancies identified by the Tarapore Committee are,

- (i) Instances of certain investments going into default within a short period of their sanction indicating possible deficiencies in the investment decision-making process;
- (ii) Investments in companies classified as NPAs;
- (iii) Fresh exposures in companies classified as NPAs;
- (iv) Investments made in one company of the group while there was already a default in another company of the same group; and
- (v) Applications for acquisition of shares at rates higher than the prevailing market rate.

When asked for its clarification on these decisions, UTI's replies broadly indicate that decisions to go in for investments in debt categories rated as less than highly secure was a balancing of

risk-reward decisions to take advantage of higher interest rates offered by these instruments so that UTI could service the returns offered to its investors. In most of the cases where fresh exposures were taken in companies classified as NPA's, the additional funds have been sanctioned by UTI as part of a consortium of financial institutions. In case of certain companies identified by the Tarapore Committee as group companies, the concerned company is not actually a part of the same group while in the two cases UTI sanctioned the funds because it felt that commercial prospects of these companies were bright and some recoveries were also made from the other defaulting group company. Regarding acquisition of shares at higher than prevailing market prices, UTI has stated that in some cases the prices are not comparable as its investment was in preference and not equity shares, while in other cases its investment was in fully convertible debentures, which were to be converted at a predetermined price and not the market price

**16.28 The Committee recommend that UTI should conduct a review of instances of investments going into default within a short period of their sanction indicating possible deficiencies in the investment decision-making process, Investments and Fresh Exposures in companies classified as NPAs, Investments made in one company of the group while there was already a default in another company of the same group, payment of brokerage on inter-scheme transactions and applications for acquisition of shares at rates higher than the prevailing market rate as identified by the Tarapore Committee. As a part of this review, it should isolate instances where there has been a violation of administrative procedures or due diligence and conduct time bound departmental enquiries in such cases. The Committee also recommend that UTI formalize a comprehensive investment policy.**

16.29 UTI's investments by way of off-market deals were Rs. 28.77 crore in 1998-99, which included Rs. 28.6 crore in two PSU's. There were no off-market investments in 1999-2000. In 2000-01 off market investments were made in two private sector companies, DSQ Software (Rs. 25.14 crore) and Numero Uno International (Rs. 4.8 crore) and the Tarapore Committee has adversely commented on both these investments.

**Based on their examination of written and oral evidence of the off market investment in the shares of DSQ Software and Numero Uno International, the Committee agree that both decisions were detrimental to the interests of UTI and its investors.**

16.30 In the case of equities, investments in the three-year period 1998-2001 amounted to Rs. 1,869 crore out of which 82 per cent was by way of private placements. UTI's investments in the primary market during the three-year period recorded a depreciation of 60 per cent. Investments in a number of companies were made despite the ERC caution against these proposals for private placements and IPO's (**Appendix-XVIII**). There were also instances where the comments of the ERC were not sought at all (**Appendix-XIX**). The UTI also has equity of Rs. 2,483 crore in 1014 thinly traded/untraded/unlisted companies and these investments have depreciated by 63 per cent. Of these, there are 36 companies where the depreciation is more than Rs. 10 crore on 31.7.2001 (**Appendix-XX**).

When Sh. Subramanyam was asked the reasons for disregarding the views of the ERC, his reply was,

"...the Equity Research Cell expresses its views. It is not mandatory. The Department receives the proposals. They undertake prima facie scrutiny of the proposals. In case of equity it is referred to Equity Research Cell. If it is a case of debt, then it will obtain the credit rating from external credit rating agencies. In the absence of Credit Rating Agencies, they will obtain it from internal sources. An Internal Credit Rating Cell has been set up.

They look into it and provide the rating. Now having obtained the recommendations, they refer the proposals to the Fund Managers. In fact in the past this was not there. But this was a new introduction that I had made, and prior to sanction of assistance, the appetite of each scheme had to be ascertained. It was not ascertained earlier. Earlier what was happening was that the sanction used to be made, and subsequently depending on wherever scope was available, the allocation was made whereas I insisted that before sanctioning, the Fund Managers themselves must come out by saying that they need this much allocation. When the Fund managers make that recommendation, they take into account, not only the recommendations of the Equity Research Cell but also Equity Research Reports available from outside sources, their own knowledge and requirement of scheme to deliver results. Based on that the decision is taken”.

When asked why the recommendations of the ERC were discarded when it had been created only for this specialized analysis, his reply was,

“I would submit that as Chairman, one goes into the advice of the next to him, that is at the level of the Executive Directors who handle the Primary Market Investments or Secondary Market Investments. ...It had not been mandatory that the Equity Research Cell had to be taken into account at the time when the papers come to the Chairman with the recommendation, apart from the Equity Research Cell reports, which had been seen by three other levels that are much higher compared to the analyst level who look into cases and make recommendations. The Equity Research Cell analysis is done at the level of Managers and Assistant General Managers, whereas the recommendations of the proposals for the primary market investment have signatures from the General Manager, Chief General Manager and Executive Director. As Chairman, one goes on the basis of what the Executive Director says. That has been the precedent in the organization”.

The current Chairman when questioned on the circumstances in which the recommendations of the Equity Research Cell could be overlooked, stated that,

“It is possible that the report available from sources other than the domestic Equity Research Cell, there are a number of other investment analysts who also put out reports and various other things, ...those could also be factored into the decision making”.

He also made the point that

“Ordinarily in the case of first investment... it would have been necessary to get an input from the Equity Research Cell”.

**16.31 Though the ERC was set up in 1997, it is only during Shri Subramanyam’s tenure from September 1998 onwards that the ERC’s comments were overlooked. This is further compounded by the fact that in all these cases UTI’s investment portfolio depreciated after the investment. In the specific case of Cyberspace Infosys, the ERC’s comments were first accepted and subsequently reversed to clear the investment. Worse, there are cases (one of which, Numero Uno International, has been examined by Tarapore Committee in detail) in which the ERC’s recommendations were not taken at all. In the light of this, the explanation of Sh. Subramanyam is not convincing. All this clearly indicates that the decisions to bypass the ERC’s recommendations were not in the interest of UTI. Given the fact that in all these cases, UTI’s investments have recorded a decline, the decisions were *prima facie* wrong and possibly malafide. The Committee recommend that UTI conduct a departmental vigilance enquiry regarding the decisions where the ERC’s views have not been taken or the ERC’s views have been overruled to ascertain whether the decisions were taken after following proper procedures or were arbitrarily made**

without due diligence. The Committee recommend suitable action against officials who are found to be involved in arbitrary decision making. The Committee also recommend that the delegation of authority to make investment decisions in UTI should be decentralised and a comprehensive investment policy should be formalised.

#### **D. SECONDARY MARKET TRANSACTIONS AND DEALING ROOM OPERATIONS**

16.32 The decisions to buy or sell securities in the secondary market were taken by a team of fund managers under the guidance of the Executive Directors. The stocks were actually purchased/sold by a separate set of dealers operating from a Dealing Room where a voice recording system was also installed. The fund managers used to send their requisition to the dealing room mentioning the shares to be bought/sold, quantity and price limits. The Executive Director (Department of Market Operations) would then decide on the requisitions and instruct the dealers who would place orders with empanelled brokers on different exchanges. The details of the orders placed were incorporated daily in a "statement of orders placed" and put up to the Executive Director (Department of Market Operations) and the Chairman for approval.

16.33 Tarapore Committee did not look extensively at UTI's secondary market transactions as a meaningful analysis of the dealing room operations would have necessitated a large dedicated team with adequate authority to conduct on-site verification of records. The Tarapore Committee observed that it

"...had access only to the "in-house" documents/data provided by the UTI; it did not have access to other vital information as bodies like regulators, who would be able to access information, to collate and derive appropriate conclusions. For instance, to examine the possibility of broker nexus, front running, benchmarking, etc., it would be necessary to go well beyond the mandate of the Committee which was to inquire into the activities of the UTI".

The Tarapore Committee therefore identified 89 companies and mandated that the pre-investigative audit of UTI's transactions in the shares of these companies should include all primary as well as secondary market transactions. It also recommended a detailed examination of the procedures and processes relating to Dealing Room operations, introduction of a well-defined risk management system duly approved by the Board and concurrent audit of the Dealing Room operations. Elaborating on these recommendations before the Committee, Shri S.S. Tarapore stated that though numerous secondary market transactions were being undertaken in the Dealing Room all the time, there was

"...no laid down authority of what a dealer limit was at different levels. So, the sanction limits may have been informally working. But there was no authority under which the dealers were operating. It was the implicit powers of the Chairman that were being exercised by the lower functionaries. So, where you did not have any limit of your operation, you operated using the Chairman's powers."

Similarly the recommendation of a concurrent audit of Dealing Room operations was made because "...all investment decisions were outside the audit system."

According to Sh. Tarapore, this was a major lacuna since when dealers operate in any other system like in banks, there is a concurrent audit by an independent person who sees

"...how the deals have been taking place contemporaneously rather than looking back over a long period of time."

Similarly, there was no “cut-loss limit” for dealers where once the loss in a particular position reached a pre-set point, the position would be liquidated to minimize further losses. It was further stated by Shri Tarapore that,

“As regards any broker dealer nexus that can emerge, one has to see whether a suitably empowered body can go into the brokers books. Now a body like ours does not have such powers. You would need somebody like—I am saying illustratively—SEBI who are regulators who can go into the broker activity.”

16.34 These deficiencies in the secondary market dealings have again been pointed out by the different auditors who were commissioned to prepare special audit reports on UTI’s transactions in 6 of the 89 select scrips recommended by the Tarapore Committee for thorough examination. The auditors have commented that there was no documentation of the thought processes or rationale that preceded the individual decisions to buy/sell shares in the secondary market and that there was no policy on minimisation of losses.

16.35 The Committee came across two other glaring lacunae in UTI’s secondary market set up. The same individual (Shri M.M. Kapoor) held both the post of Executive Director (Department of Market Operations), in charge of secondary market dealing operation as well as of Executive Director (US-64 Fund Management and Equity Schemes Fund Management), in charge of fund management transactions of US-64 as well as the equity linked schemes of the UTI. That there was a clear conflict of interest inherent in this was also known to the UTI management, as the then Chairman, UTI in his letter dated 30.6.2001 to the Ministry of Finance mentioned that one of the proposals to the Board of Trustees to strengthen the organizational set up was that,

“The Dealing Room, which executes trades on a day to day basis would be placed under an Executive Director, separate from the fund management group”.

16.36 UTI’s own vigilance enquiry into its off market transaction with CSE discovered that the cassettes for the period January to June 2001 from the voice recording system which records the conversations between dealers and brokers in the dealing room were damaged, all dealers had access to these tapes and the pass word of the voice recorder was also known to all the dealers. This makes a mockery of UTI’s surveillance of its dealing room operations.

**16.37 The lack of a proper risk management system in secondary market operations, the absence of any laid down guidelines for dealer authority and stop-loss limits to liquidate loss making positions, the absence of any documentation of the rationale for secondary market transactions in particular shares, the concentration of power for both fund management as well as dealing room operations in one person and the lack of any security system to preserve the confidentiality of the dealing room’s voice recording mechanism lead the Committee to conclude that the absence of laid down procedures for secondary market transactions allowed the UTI management to purchase and sell any quantity of any share in the secondary market without any accountability. The Committee recommend a thorough enquiry of the secondary market transactions in the shares of the 89 companies identified by the Tarapore Committee. This enquiry may be conducted by SEBI for the period 1992-1993 to 2000-2001 by looking at these transactions at the level of UTI’s dealing room and at the level of individual brokers and responsibility be fixed for any incidents of broker-UTI dealer nexus, front running, benchmarking, etc. As the lack of any documentation of secondary market transactions will make an audit trail difficult, the Committee desire that SEBI devise suitable mechanisms for identifying wrongdoing. Steps may be taken thereafter by SEBI and UTI to take action against the wrongdoers including referring appropriate matters to an independent investigative agency.**

16.38 UTI has informed the Committee that it has taken several steps like setting up a separate dealing department, a middle office for overseeing the performance of brokers, introduction of a performance grading system for brokers, monthly internal audit of dealing room operations and a program for computerization and integration of dealing room, middle office, back office and fund market operations in response to the Tarapore Committee's recommendations.

**16.39 The Committee desire that UTI also immediately address the issues of concurrent audit of dealing room operations, documentation of decisions regarding secondary market transactions, proper management and security of the voice recording system in the dealing room, introduction of stop loss limits for the dealing room operations and separation of responsibility and authority for fund management and dealing room operations. The UTI Board of Trustees and the Executive Committee including the Chairman should have ensured that these lacunae were attended to in time.**

#### **E. SCRUTINY OF SPECIFIC INVESTMENT DECISIONS**

16.40 The Tarapore Committee also undertook a closer examination of investments made by UTI in 89 companies for the period July 1991-June 2001, which were in the public glare and were of concern to investors. The examination is based on the information for the period July 1997 to June 2001, as the UTI could not provide information for the earlier period. The list of these 89 companies is given in **Appendix-XXI**.

16.41 UTI provided details of its debt investments in 31 of these 89 companies out of which 29 were unlisted. The debts to 12 of these companies have become NPA's. The rating of the debt instruments of a number of these companies is currently below investment grade though UTI has not been able to provide their rating at the time of investment. UTI had a Credit Rating Cell (CRC), which rated 14 of these instruments as they had not been rated by any outside agencies and of these 6 have become NPA's. 3 of the debt instruments were not rated at all and one of these has become an NPA.

16.42 UTI supplied the Tarapore Committee information about 84 companies in which it had made equity investments. In 2000-2001, the equity investments in 33 of these companies have depreciated by more than Rs 10 crore, in 14 companies it is between Rs 5 crore and Rs. 10 crore and in another 15 it is between Rs 1 crore and Rs 5 crore. Some of these investments have recorded depreciation in the very first year and there are others that have depreciated over the past year or two, but UTI not only held onto these stocks, it made further purchases in this period.

16.43 The Tarapore Committee also conducted a comprehensive review of investment decisions in 19 out of the 89 companies identified by them. The investment decisions were then classified as prudent or imprudent based on the available inputs at the time the decision was taken, and right or wrong in retrospect. The definition of a prudent or imprudent decision has been outlined as follows:

"A prudent decision is one in which the established processes and norms have been complied with, and while being made, all relevant factors are taken into account, including the promoter or counter-party risk, the industry performance, liquidity etc. An imprudent decision would be one in which these processes/ safeguards are absent. A prudent decision can be right or wrong and an imprudent decision can also be right or wrong. A prudent decision can turn out to be wrong as, subsequent to the decision, the situation turns adverse which may be beyond the control of the decision taking authority.

Equally, an imprudent decision can turn out to be right as, for instance, the decision taking authority exits from an investment before the risks, which should have been reckoned but were not considered, crystallized; while such decisions are fortuitously right, they could obviously not fully meet with the criteria required for an appropriate decision. An imprudent investment decision which turns out to be wrong is obviously the worst of the various combinations of decisions and their outcomes. Ideally, an appropriate decision by a fund manager would be a prudent decision which meets all the investment policy norms such as a strong research process, proper decision taking rules, within an investment committee, with well laid out decision taking rules, valuation logic, asset allocation policy and prudent investment and liquidity norms; ultimately, the decisions have to be evaluated from the viewpoint of maximizing investor interests on a consistent basis. The probability of a prudent investment decision turning out right is greater than it turning out wrong."

16.44 The analysis of the investment decisions in these 19 companies showed that in 18 cases the decisions were *prima facie* imprudent and turned out to be wrong while in one case the decision was *prima facie* imprudent but turned out to be right. While this is not surprising as the cases picked up by the Tarapore Committee were those in which public concerns were raised, it raises disturbing questions about the decision making process in the UTI and whether this process was driven by interests other than commercial ones. However, as it had relied only on the documents provided by the UTI and did not have the time nor the kind of access to information which regulatory bodies have to examine the possibility of malpractices like broker nexus, front running, benchmarking etc., the Tarapore Committee recommended comprehensive audit reports in all these cases. It recommended that this should be followed by an examination by a suitably empowered pre-investigative body, which would decide about further investigation in these individual cases. As audit reports already existed in the case of one company, it was recommended that the auditors reports as well as the Tarapore Committee's findings on this company should be remitted directly to the pre-investigative body for detailed examination.

16.45 For the investment decisions in the remaining 70 cases, the Tarapore Committee recommended that these should also be subject to a comprehensive audit. The Tarapore Committee drafted a standard note for auditors detailing the aspects to be examined, the letter to be addressed by the auditors to the UTI while forwarding their report as well as a format for submitting the audit report.

16.46 As a follow up to these recommendations, the UTI commissioned audit firms to conduct the special audits of its investment decisions in 18 companies. The audit reports in respect of 8 of these were put up to the Board of Trustees on 26.4.2002 in the first tranche and of 10 companies in the second tranche on 19.9.2002. The Board decided that certain transactions in the case of these companies be referred to a pre-investigative body. In the case of one company for which the Tarapore Committee had not suggested another special audit (owing to the fact that three independent audits had already been conducted in the past), UTI decided to refer the matter directly to the pre-investigative body. UTI wrote to the Ministry of Finance seeking advice regarding the appropriate pre-investigative body to which these cases should be referred. The Ministry informed UTI on 17.6.2002 that the Advisory Board on Bank, Commercial and Financial Frauds constituted by the Central Vigilance Commission (CVC) would advise whether the irregularities pointed out by the Tarapore Committee and the special audits warrant filing a regular chargesheet and/or departmental action. UTI has been asked to send all the papers to the Advisory Board for their examination. The papers in respect of 19 companies have been filed by UTI with the Advisory Board on various dates during the period 8.8.2002 and 8.11.2002.

16.47 The Committee deplore the imprudent manner in which stocks were purchased and retained, leading to a host of malpractices which require comprehensive audit and pre-investigation by a suitably empowered body before proceeding to the investigative level. The Committee are satisfied with the process adopted by UTI in respect of the investment decisions in the case of 19 companies. The Advisory Board on Bank, Commercial and Financial Frauds should expeditiously take a final decision on these. The Committee recommend that the procedure suggested by the Tarapore Committee also be adopted in the case of investment decisions in the remaining 70 cases, as this meets the ends of natural justice. The Committee desire that the entire process should be completed within six months of the presentation of this report to Parliament. There is no cause for further delay in this matter.

#### F. INVESTMENT IN CYBERSPACE INFOSYS LTD.

16.48 One of the investments made by the UTI which was raised in Parliament, was in Cyberspace Infosys Ltd. This investment figures in the list of investments in which the recommendation of the ERC against the investment decision was not followed (see **Appendix-XVIII**). The CBI has registered a case on 18.7.2001 against M/s Cyberspace Infosys Ltd., its promoter Shri Arvind M. Johari, Shri P.S. Subramanyam (Ex-Chairman UTI), late Shri M.M. Kapoor (ex-Executive Director, UTI who has since expired), Shri S.K. Basu, (Executive Director, UTI), and Smt. Prema Madhu Prasad (General Manager, UTI) and other unknown private persons and officials of UTI. The CBI's allegation is that these persons have entered into a criminal conspiracy to cause wrongful loss of approximately Rs.32 crore to UTI. According to the CBI, in pursuance of this criminal conspiracy, the top executives of UTI decided to subscribe to 3,45,000 shares of M/s Cyberspace Infosys Ltd. at an exorbitant price of Rs. 930/- per share against the expert professional advise of their own Equity Research Cell and Fund Managers. Further, M/s Cyberspace Infosys Ltd. and its directors diverted the amount received from UTI for purposes other than for which it was solicited from UTI. BSE has suspended trading in shares of M/s Cyberspace Infosys Ltd. due to dishonest business practices and its shares are at present valueless, resulting in a wrongful loss of Rs. 32.08 crore to UTI and corresponding wrongful gain to the accused persons.

16.49 The Committee questioned Sh. Subramanyam regarding this transaction. Shri P.S. Subramanyam recounted his version of events, which led to the decision to invest in the company.

"That case was sanctioned by the UTI in July 2000. The proposal had been put up on 17th July or so. That again was a recommendation which had come from the Department and they had examined the case. They found that the request for subscription to private placement be declined. I had merely initialed on that since I went along with the recommendation of the team. After, I think, four days, the same team of officers who had processed the case, came up with the proposal. They came in person to my cabin and said they have reviewed and there is a possibility of arbitrage. That means they had bought certain shares in the secondary market of that company in the past and that could be sold. They had sold that also. At least, the existing investor holding would get substituted by the new subscription to the private placement. Accordingly, they are recommending sanction of that issue. Since three of them had come in person and mentioned that to me, I initialed on that note also".

When asked the reason for the complaint filed by the CBI, he stated,

"There is an allegation which has been made saying that there have been some extraneous considerations on which the concerned subscription has been made by the UTI. There is an allegation of corruption".

When asked as a prudent person, why the fact that the officers came back to him with a recommendation contrary to what they had given a few days earlier did not strike him as rather dubious, Shri. Subramanyam replied,

"It was a listed company. It was quoted company. It was a dividend paying company. It pays dividend regularly. In the previous two years, the company had registered rapid heights in terms of turnover and profits. The company had also clearly mentioned that they had very strong people on the Board as well as in the Senior Management Team".

When asked whether he had asked his officials to give in writing, the reasons for a change in their recommendation, so that he could have taken an informed decision in the matter, he replied,

"Since the three of them came together, it is normal to rely on the senior team and also that, perhaps, I could have asked them to put that in writing what they mentioned".

When asked if it never occurred to him that there may be an extraneous consideration and that somebody maybe interested in UTI investing in the private placement of this company, his reply was,

"I did not doubt the bona fides of my team".

When asked whether in hindsight, now that all the facts were available, he thought that there was some extraneous pressure, his answer was,

"On hindsight, it would be too much to jump to that conclusion because when the decision was taken, at that point of time, the Johari brothers had met the senior members".

and added that,

"They did not meet me. Nor did the broker concerned have any meeting with me..."

He stated that the promoters had given a professional presentation to the top management, but neither the promoter nor the concerned broker had met him. He confirmed as a fact that much prior to the decision, the entire financial press was in praise of the company, calling it blue-chip scrip. When it was pointed out that the fact that company's scrip (which was purchased at Rs.930) was currently valueless, led to the obvious conclusion that the fundamentals of the company were not sound, he stated that there was no reason to doubt the fundamentals of the company at the time as,

"...the annual accounts and quarterly results published carried a good story about the company and the financial press had carried good stories about the company at that time."

**16.50 The Committee put on record, their disapproval of the decision making process, rather the lack of it, in this private placement. The Committee conclude that UTI's investment in sanctioning Rs. 32.08 crore towards the purchase of 3,45,000 shares of Cyberspace (of a face value of Rs. 10) at a price of Rs.930 per share was irregular and violated norms of prudential decision making and notwithstanding Shri Subramanyam's denials, possibly influenced by extraneous considerations. The Committee are aware that criminal proceedings in this matter are pending, but see no reason why departmental proceedings should not be initiated simultaneously**

in case of the officials concerned. In this regard RBI's recent circular dated 3/5/2002 addressed to all commercial banks regarding bank frauds, specifically states, "...departmental action against officials involved in bank frauds should invariably be initiated simultaneously with criminal action with a view to ensuring that internal fraudsters are immediately punished even if criminal cases against them drag on. At present, there is a tendency among banks to wait for the outcome of criminal action against officials involved for taking departmental action. In view of the salutary effect of this principle, we advise that you initiate departmental action against officials involved in fraud cases simultaneously with criminal action." The Committee are of the opinion that UTI should also follow this principle, and initiate a time bound departmental vigilance enquiry in this matter. As recommended earlier this should also be done in all cases where ERC's recommendations were not sought or its recommendations were overruled.

#### G. OFF MARKET INVESTMENT IN NUMERO UNO INTERNATIONAL

16.51 UTI made two off market investments in 2000-2001, both of which are examples of lack of prudential norms in UTI's investment decisions. The off market investment in the purchase of shares of DSQ Software from Calcutta Stock Exchange (CSE) is discussed in Chapter XVIII. The other off market investment in the shares of Numero Uno International (NUI) was examined in detail by the Tarapore Committee as part of the extensive review of 19 of UTI's investment decisions. The Tarapore Committee concluded that UTI's investment decisions in respect of NUI were prima facie imprudent and turned out to be wrong and suggested a thorough on site audit before remanding the matter to a pre-investigative body. It came to this conclusion on the basis of the following facts:

- (i) UTI invested Rs 10 crore in the equity of NUI, an unlisted company by way of two off-market/private placement deals of Rs 5 crore each in March and July 2000. The details of investments are:

Year ended June	No. of Shares held	*Average cost per share	Amount (in Rs. Crore)		
			Closing cost	Fair Value	Depreciation (-)
2000	100,000	Rs. 500.00	5.00 crore	0.07	(-) 4.93
2001	**400,000	Rs. 239.00	9.57	2.94	(-) 6.73

\* Worked out on an approximate basis.

\*\* includes 2,00,000 bonus shares

- (ii) UTI received a proposal along with an Information Memorandum dated 15/2/2000, from Ambit Corporate Finance Pvt Ltd. (ACFL), a company retained by NUI for arranging this transaction. The Memorandum stated that the shareholding of NUI comprised 34,79,000 shares of Rs.10 each held by Mr. Sanjay Khan and his family. It did not mention any details about the status of the company, viz., date of incorporation, listed or unlisted, pattern of shareholding or the authorized/paid up capital, statutory dues of the company, if any, the number of shares on offer for sale and the share price the company was expecting. Copies of audited balance sheet and profit and loss account were not furnished. There was no mention about any resolution having been passed by the Board of Directors of NUI regarding offer of shares by the company to an institution like UTI or for going public from any specific date, the risk factors associated with the project or the applicability of the SEBI regulations to the offer.

- (iii) The Department of Investment of the UTI put up a proposal *vide* its note dated 6/3/2000 proposing to invest Rs 43 crore purchase 869750 shares at Rs.500 per share (Rs. 10 as the face value and Rs.490 as the premium) reducing the stake of the promoters in the company to 80 per cent. The proposal did not mention how the quantity of shares to be purchased was determined and how the price was fixed at Rs.500 per share, specially since the company's own offer letter was silent on this. Infact, the office note was silent on all the important issues, which were missing in the company's Memorandum, and no attempt appears to have been made to elicit information on them. No financial institution had appraised the proposal and it was not sent for scrutiny to the Equity Research Cell of the UTI. The source of financial data given in the office note was not mentioned and there were no comments on its accuracy/reliability as the audited accounts were not available with UTI.
- (iv) The financial parameters given in the office note projected a quantum jump in NUI's profits in the remaining part of the financial year. These figures were not accompanied by any analysis although they were stated to be inclusive of the performance of a proprietary firm of Mr. Sanjay Khan, which had been merged with NUI just two months before the letter of offer from NUI. The UTI did not seek to ascertain the financial health of NUI before and after the merger of the two firms.
- (v) While the proposal contained in the office note of 6/3/2000 was under process, a note was recorded by an official of the UTI stating that a fax had been received from the arranger advising that only Rs. 5 crore was left for subscription. Copy of the fax was not supplied and the date of its receipt was not mentioned in the office note. Further notings suggested that since the Fund managers had agreed to bid for Rs.43 crore, UTI could subscribe to the Rs.5 crore left for subscription. The Chairman approved the proposal on 9.3.2000. Even at this stage, there was no noting to suggest if the UTI had made any inquiries about the financial standing of the company and the details of other bidders.
- (vi) The disbursement of Rs 5 crore was made on 13.3.2000 and allocated to Income Schemes (Rs. 1.75 crore), US-64 (Rs.1.625 crore) and Growth Schemes (Rs. 1.625 crore). A copy each of the company's resolution regarding allotment of shares to UTI and the letter of allotment was not supplied. The Chairman's approval was reported along with some other approvals to the Executive Committee at its meeting held on 22.3.2000 without any information about the status of the company and the premium paid on each share. This investment of Rs. 5 crore made in March 2000 depreciated by Rs. 4.93 crore by June 2000 so that the market value of the shares was down to UTI had Rs. 7 lakhs, a depreciation of 98.6 per cent in around four months.
- (vii) After the first disbursement of Rs 5 crore had depreciated by Rs. 4.93 crore, UTI received a fax dated 14.6.2000 followed by a letter dated 24.7.2000 from Sun Rama Exports Pvt. Ltd. offering one-lakh shares of NUI held by it without indicating any price. The letter which was on the letterhead of Sun Rama Exports Pvt. Ltd was signed by the Chairman of NUI, and stated on behalf of NUI—

"I am pleased to confirm in my capacity as the Chairman & Managing Director of Numero Uno International Ltd, that we have appointed DSP Merrill Lynch Ltd., as the Lead Managers for the forthcoming IPO, and that tentative date for receiving bids has been fixed for 18 September 2000, while that of the Public Offer is 27 September 2000.

I also confirm that the price of the IPO would be higher than your net buying price, and should you incur any loss on this account, we would compensate you for the same.

With these assurances from us, please now arrange to release the cheque for the consideration, as early as possible”.

- (viii) On receiving the fax and the letter, the Department of Investments, without drafting an office note on the proposal with its analysis and recommendations processed the offer on the fax and an official in UTI recorded on the fax:

“We had earlier taken one lakh shares of Numero Uno at the rate of Rs.480 per share for off-shore international fund. We may take another one lakh shares for our domestic income scheme, the co. is coming with IPO in September 2000. The Chairman of the co. has confirmed to compensate UTI if the IPO price or subsequent pricing is less than this price”.

In this context Tarapore Committee has observed that this noting was inaccurate because:

- (a) The earlier shares were purchased at Rs.500 per share and not at Rs 480 per share. The note did not mention that the value of these shares purchased in March 2000, had been totally eroded.
- (b) The shares earlier purchased were allotted to the domestic schemes and not the off-shore fund and it was not clarified whether the earlier purchase made for domestic funds had been transferred to off-shore funds and if so, the date and if the loss was booked by the domestic scheme before being transferred to the off-shore fund.
- (c) Earlier, the IPO was slated for June 2000. No reasons were given for the postponement from June to September 2000. The proposal lacked information on all the relevant issues noticed in the case of first investment of Rs. 5 crore. No enquiries were made as to how Sun Rama Exports Private Ltd. made the offer for sale of shares stated to be held by it whereas the Memorandum of Information had earlier stated that Mr. Sanjay Khan and his family held all the shares.
- (d) The noting made on the fax made no mention on the state of the earlier investment, the value of which had eroded completely by the time of this new proposal. Despite this, the price was fixed at Rs.480 per share, again without any assessment from the ERC. The Chairman approved the proposal subject to an undertaking from the company that it would compensate UTI with reference to the IPO pricing.
- (e) The company had not gone public as yet and there was no information on the book value of the company's shares.
- (f) The UTI received 2,00,000 bonus shares during the year 2000-01. Copies of relevant papers including letter of offer, copy of board resolution, company's audited accounts showing availability of adequate reserves for issue of bonus shares, etc. were not supplied.

16.52 On the basis of Tarapore Committee's observations on this transaction, the Committee examined both the former and current Chairman of UTI. The former Chairman,

Shri P.S. Subramanyam on being asked to explain the investment in the light of the fact that the ERC's recommendation was not called for, stated,

"In the case of Numero Uno, I remember, of course, sanction note was brought to me personally by the Executive Director concerned. It did mention that this valuation has been undertaken by Ambit International Services. Sh. Ashok Wadhwa was the Chief at that time and reputed consultant. He had undertaken an evaluation, which was promoted by famous film maker Sh. Sanjay Khan. It was also mentioned to me at that time when it was brought before me that his son-in-law Hrithik Roshan, who was a rage in the market would be joining and that they would be coming up with programmes like Sanjay Khan's Mahabharat. Like that he had a series which he wanted to bring out and that was to make a public issue and then there was also commitment which was given, I remember in this, that the promoter would make good if there is any loss which the UTI would face at the time when the IPO is made. It would be made by the promoter. That undertaking still exists".

When the company's undertaking about compensating UTI for any loss incurred by it was pointed out to the current Chairman UTI on 5.4.2002, he conceded that no action had been taken till date on this undertaking and that immediate action would now be taken. Subsequently, the UTI has informed the Committee in June 2002 that UTI had called the joint meeting of the institutional shareholders and promoters of the company in April 2002, in which the promoters were advised to give an exit route to the institutional shareholders at the earliest. UTI had also sent a letter in April 2002 followed by reminders in May and June 2002 for giving an exit route to it. It was informed that the reply from the company was awaited and meanwhile, UTI was seeking legal opinion for initiating legal action.

**16.53 The Committee highlight this transaction as another serious violation of norms in UTI and accordingly recommend investigation into the entire transaction, including possible extraneous considerations which might have actuated it. Moreover, the Committee deplore the failure of UTI to pursue recovery proceedings against a corporate, which sought investment from UTI on the basis of an undertaking that it would compensate UTI for any loss in the transaction. The Committee recommend that UTI should vigorously pursue all civil and criminal avenues to recoup its investment in Numero Uno International in a time bound manner. UTI should review the role of both Numero Uno International as well as the company that arranged the transaction and take action against them in case there is evidence that they misrepresented the true affairs of the company while seeking investment from UTI. The Committee also recommend that UTI should take immediate steps to hold the concerned officials who processed this transaction accountable and take action against such officials. Besides other actions, law permitting, UTI should initiate civil proceedings of damages against its concerned officials including the then Chairman to recover the losses sustained by its unit holders for a decision which they took without due diligence and in violation of UTI's norms and procedures.**

#### **H. ASSURED RETURN SCHEMES**

16.54 The UTI launched assured regular income plans under the Monthly Income Schemes (MIS) series in the 1980's in which the capital and returns were guaranteed by the UTI. Between 1994 and 1996 since SEBI had concerns regarding the returns being assured, UTI's monthly income schemes were launched as NAV-based products with no capital guarantee. In 1996, SEBI came out with the SEBI (Mutual Funds) Regulations, 1996 which allowed assured return schemes with the stipulation that no guaranteed return should be provided in a scheme unless the sponsor or the asset management company of the concerned mutual fund fully guaranteed the return and the manner of meeting the guarantee, in case of a shortfall was stated in the offer

document of the scheme. The UTI started offering assured returns once again. The Executive Committee of the Board of UTI at its meeting held on 13.1.1997 approved the launch of MIP 97 (the first of many such schemes) as a fully assured return scheme, which guaranteed a dividend of 14%. It was stated in the Memorandum to the Executive Committee,

“There is a definite investor preference for fixed income schemes that give assured return for the full term of the scheme. We were in correspondence with SEBI to allow the Trust to offer assured returns under Monthly Income Plans and pleaded with SEBI that in the event of shortfall if any, the same may be met out of the Development Reserve Fund. SEBI has since advised that they have no objection to the Trust’s proposal to use the DRF to meet the shortfall in the guaranteed scheme and to launch schemes with assured returns purely as an interim measure till such time UTI sets up a separate Asset Management Company”.

The Executive Committee approved the scheme with some minor modifications in the terms and conditions as suggested by the Chairman. It is pertinent to point out here that the Executive Committee of the Board of UTI is entirely dominated by the IDBI. Out of the four members, two are IDBI nominees, the Executive Trustee is an IDBI appointee and the Chairman is appointed with the concurrence of the IDBI.

16.55 Subsequently, UTI launched eight other fully assured schemes between July 1997 and June 1998. As on 31.1.2002, UTI had twenty-five assured return schemes which had a projected shortfall of Rs 8189 crore (**Appendix-XXII**). This figure may change in future depending on the performance of the capital markets. Five of these assured return schemes are maturing in 2002 and the projected shortfall as on 31.12.2001 was Rs 2632 crore. UTI, through a letter dated 21.1.2002 informed the three principal contributing institutions—IDBI, LIC & SBI about this projected shortfall and that the Development Reserve Fund of the UTI would not have sufficient funds to meet it. These institutions were therefore requested to make up the shortfall in their role of sponsoring institutions. In their replies to UTI, all these institutions denied their liability, as according to them, they are not sponsors of the UTI. The extract from a Note appended to IDBI’s letter dated 8/2/2002 to UTI repudiating its liability is reproduced below:

‘b. Whether the SEBI Regulations as such impose any automatic liability on a ‘sponsor’ in respect of assured/guaranteed return scheme?’

The SEBI Regulations as such do not impose any automatic liability on the sponsor for any shortfall under any assured/guaranteed return scheme of a mutual fund. The relevant provision contained in (SEBI) Regulation 38 is reproduced below:

#### *Guaranteed returns*

38. *No guaranteed return shall be provided in a scheme:—*

- (a) unless such returns are fully guaranteed by the sponsor or the asset management company;*
- (b) unless a statement indicating the name of the person who will guarantee the return, is made in the offer document;*
- (c) the manner in which the guarantee to be met has been stated in the offer document.*

It would be clear from the above provision that a mutual fund cannot frame any scheme for guaranteed returns unless the ‘sponsor’ provides a specific guarantee to stand by

any shortfall and a specific statement indicating the person who has given such guarantee is made in the relevant offer document. *Obviously, UTI did not frame its assured return schemes pursuant to and in compliance with the aforesaid provisions nor has IDBI executed any guarantee in this regard. UTI cannot therefore take help of the said provision.*"

**16.56 The Committee are of the view that UTI cannot escape its responsibility to investors in its guaranteed assured return schemes. Those responsible for launching these assured return schemes must be held accountable for their actions and proceeded against. Moreover, the Committee does not find the position taken by IDBI as guarantor of UTI to be in consonance with the canons of sound corporate governance. The Executive Committee of the Board of UTI which sanctioned these schemes in 1996-97 and 1997-98 in violation of SEBI guidelines comprised Chairman, UTI appointed with the concurrence of IDBI; CMD, IDBI as its nominee; Executive Trustee appointed by IDBI and another trustee functioning as the IDBI nominee. It is therefore clear that all functionaries who participated in this decision represented IDBI. Therefore the Committee cannot accept IDBI's claim that UTI did not frame its assured return schemes within the knowledge of IDBI as guarantor. IDBI should hold its appointees responsible for not framing UTI's assured return schemes in compliance with SEBI guidelines.**

16.57 SEBI was asked to explain its role in clearing and regulating these assured return schemes as they were launched under SEBI regulations. In response, SEBI has presented a comprehensive write up about UTI's assured return schemes, a gist of which is given below:

- (i) On the directions of the Central Government, UTI subjected itself to voluntary compliance of SEBI (Mutual Fund) Regulations for all its schemes, which were launched after 1.7.1994. The UTI has always highlighted its problems in complying with SEBI (Mutual Funds) Regulations in view of the size of its assets, its General Regulations and the provisions of the UTI Act.
- (ii) UTI had launched assured return schemes since 1982, much before the SEBI Act was passed in 1992. Thereafter, the mutual funds sponsored by public sector banks and institutions also launched such schemes. UTI had considerable experience in managing these schemes over a long period of time.
- (iii) SEBI (Mutual Funds) Regulations 1996 permitted the mutual funds to launch assured return schemes provided such returns were fully guaranteed by the sponsor or the AMC and the name of the guarantor and the manner in which the guarantee would be met was mentioned in the offer document.
- (iv) Till 1996, UTI was assuring returns for one year at a time. It also incorporated a clause in its offer documents stating that in case of income being inadequate, investors would suffer loss of unit capital to that extent.
- (v) UTI represented to SEBI that they should be allowed to assure returns for more than one year at a time. They cited the instances of other development financial institutions like IDBI and ICICI offering assured return bonds for far longer duration of 7 to 20 years with returns over 16%. UTI asked SEBI to consider its past record, the social security orientation and investor's persistent demand and allow it to start longer term assured return schemes instead of the one year assurance that was being cleared by SEBI at that time. It also argued that protecting an assured annual rate of 15% would not be difficult considering that the Trust had not faced any such situation in the past and the funds would be prudently deployed within 6 months to the extent of 90% in fixed income securities. The then Executive Trustee of UTI, wrote to SEBI on 27.8.96 stating that UTI had neither a sponsor nor an asset management company and requested that the UTI's Development Reserve Fund should be considered as the

guarantee for the purpose of underwriting capital redemption and assured returns. It was also stated that once UTI was restructured with the constitution of an AMC the Development Reserve Fund (DRF) would provide the AMC with enormous financial muscle. It was finally mentioned that as the resources of UTI are invested in the capital markets, such a regulatory dispensation would contribute to the revival of capital markets.

- (vi) SEBI has stated that it was in this context that UTI's offer documents, which included assurances for the full five years, were cleared from the beginning of 1997 on the strength of the DRF of UTI. While clearing UTI's offer documents of assured return schemes between 1996 and 1999, SEBI raised queries from time to time on the adequacy of DRF, any likely shortfall, information on existing assured return schemes etc, and also advised UTI to make disclosures on these points in the offer documents and not to pay dividend from unit capital.
- (vii) In response to these queries, SEBI received specific assurances from the UTI management from time to time about UTI's ability to meet its assured return commitments. In May 1998, UTI was advised to give a detailed note on the adequacy of DRF to meet the commitments under their assured income schemes. In response, the then Chairman UTI, Mr. G.P. Gupta, sent a note on 12.5.1998 to Chairman SEBI in which he mentioned that no shortfall was expected in assured return schemes on their maturity and chances of DRF being utilized to meet this shortfall were rather remote. He claimed that in the most unlikely event of shortfall, the extent of such shortfall would be very small in comparison to corpus of the DRF, which was Rs 600 crore on 30.6.1998 and which was expected to grow at the rate of Rs 125 crore per annum to reach Rs 1250 crore by 30.6.2003. He specifically stated that as per estimates, the income and unrealised appreciation was in excess of liabilities in the 8 schemes, that had been launched since 1997 backed by an explicit guarantee from the DRF. He mentioned that UTI had redeemed 33 schemes during the last decade with a capital value of Rs. 9,600 crore and fully met the assurances and in many cases gave more than what was assured. He also clarified that UTI had never had to utilize DRF for meeting the assured returns in any of its previous schemes. An explanation was also sought from UTI on the negative reserves in existing assured return schemes in November 1998 to which their Executive Director, Mr. A N Palwankar replied *vide* his letter dated 26.11.98 stating that every assured return scheme displays deficit in its early stages which reduces subsequently and often ends up with surplus. The key reasons cited for this initial deficit was stated to be the time taken to build up the portfolio and the fall in BSE Sensex in the previous six months, while the obligation to distribute income started from the day of investment. He submitted that the shortfall as on date for assured return schemes guaranteed by the DRF was Rs. 444.11 crore and for assured return schemes with no such guarantee, it was Rs. 372.92 crore. It was also stated that the shortfall was likely to be met through active trading and appreciation in the value of fundamentally sound equity stocks held in the portfolio. He reiterated UTI's track record of not having failed in meeting the assured returns in the past. SEBI also sought UTI's comments on a study done by an auditing firm on the shortfall of UTI's guaranteed assured return schemes. In response the then Chairman UTI, Mr. Subramanyam, sent a note to Chairman SEBI *vide* letter dated 15.2.1999 in which it was stated that there was nothing that prevented UTI from selling its strategic investments held under DRF and that UTI would realize the value of these holdings at an appropriate time if it got the right price. It was also mentioned by UTI that DRF corpus was adequate to cover up for the current and future deficits, if any, in the schemes and that the shortfall at maturity in the

guaranteed return schemes as calculated by the report was Rs 346 crore which was sufficiently covered by the DRF's existing corpus of Rs. 600 crore. In this context the UTI felt that the issue of government or any other institution bailing out UTI because of insufficiency of DRF was hypothetical. He also assured SEBI that UTI had a thorough internal monitoring mechanism for all of its schemes that each scheme had a fund manager who monitored its performance. In addition an asset management committee comprising two EDs, one UTI trustee and external expert meet 5-6 times a year to review performance of the schemes. He also stated that a proposal for full portfolio disclosure of all schemes was under consideration. On SEBI's request, Mr. P.J. Nayak, the then Executive Trustee of UTI, made a presentation, on the MIP 99 scheme in a meeting with SEBI on 16.2.99. He justified the launch of MIP 99 scheme by saying that not even a single assured return scheme defaulted in its assurances and DRF was never used. He also mentioned that in all 25 schemes, which had matured by that time, UTI paid bonus/appreciation on maturity from 0-40%. Subsequently, he also submitted a detailed letter in this regard.

- (viii) In June 1999 the DRF was Rs. 825.01 crore as against negative reserves of Rs. 858.05 crore. UTI stopped assuring returns for 5 years at a time in the middle of 1999 and switched to assuring them for one year at a time.
- (ix) SEBI has pointed out that most of the time UTI's returns in its assured returns schemes have been lower than the average returns paid by other mutual funds. UTI's own bond fund scheme launched in 1998, which was not an assured return scheme, has given an average of 12.9% return since inception. SEBI has analysed why the assured income schemes of UTI could not fulfill their commitments. Payment of dividend out of unit capital by UTI, contrary to SEBI's advice, is one of the reasons for the problems being faced by the assured return schemes today. Another reason for the low yields was the overemphasis on equity investments. As per the offer documents of these assured return schemes, UTI could invest up to 100% in debt securities and a maximum of 30% of the funds in equity shares of companies. There was therefore no compulsion on the part of UTI to invest in equity shares. SEBI has also observed from the half-yearly portfolios of the assured return schemes as on 31.12.2001 that NPAs have contributed significantly to erosion in the NAVs of the assured return schemes. For example, MIP-95 scheme had NPAs as a percentage of NAV at 37.90%, MIP-97 had 17.95%, MIP-97 (II) had 17.47% IISF-97 had 10.42%, IISF—97(II) had 16.93%, MIP 98 had 13.11% and IISF-98 had 18.62%. No other mutual fund has such a high level of NPAs. UTI's own Bond Fund scheme which is a debt-oriented scheme launched in 1998 showed NPAs of 0.42%, and gave returns of 12.9% since its inception which was in line with performance of most other mutual funds schemes. SEBI stated the main reason for high level of NPAs, according to SEBI may be that the UTI had earlier given term loans, which were later transferred to schemes regulated by SEBI. Even non-performing loans were transferred to these schemes. Despite SEBI's repeated advice, UTI did not disclose the full portfolio of its schemes as was being done by all other mutual funds. Further, according to SEBI, UTI disclosed only 75-80% of these portfolios and did not disclose the bad investments. Thus all along, nobody was aware of the quality of assets of UTI. UTI has confirmed that such inter-scheme transfers of loans did take place and has also informed the Committee that it has stopped the transfer of term loans to assured return schemes from 30.12.2000 and of non-performing loans to assured return schemes from 14.9.1998.
- (x) SEBI has stated that it does not intervene in the day-to-day investment decisions of any mutual fund for which its management is fully accountable. Under SEBI regulations

and guidelines, the mutual funds are required to exercise due diligence in their investment decisions and the boards of AMCs and trustees are required to periodically review the performance of the schemes. The Executive Committee approved the assured return schemes of UTI. The Executive Committee is set up in accordance with the provisions of UTI Act and comprises of the Chairman, the Executive Trustee (if appointed by the IDBI) and two other trustees nominated by IDBI. The Board of Trustees of UTI has always comprised of eminent persons and experts in the field so investment/finance including senior officials of Government, RBI, banks and financial institutions. UTI had maintained till as late as February 1999 that the issue of Government or any other institution bailing out UTI because of insufficiency of DRF was only hypothetical. SEBI has to rely on the declarations and assertions made by intermediaries from time to time, whether at the time of registration or for the purpose of disclosures in the offer documents at the time of public or rights issues. There was, therefore no reason for SEBI to disbelieve the statements and commitments made by the Chairmen and other senior officials of UTI, the largest mutual fund in the country set up under the Act passed by Parliament. These statements and commitments were made through their letters or during the meetings held with senior officials and Chairman of SEBI.

**16.58** The Committee are of the view that despite SEBI's queries and suggestions, UTI continued with policies which were detrimental to its assured return schemes. The Committee however feel that the letter of 26.11.98 from UTI which mentioned that the shortfall as on date for assured return schemes guaranteed by the DRF and other schemes with no such guarantee added up to Rs 817.03 crore against a corpus of Rs 600 crore in the DRF was a sufficient indication to the regulator not to clear any further schemes despite which two more of such guaranteed return schemes were cleared before future schemes were finally changed to assure only the first years return and the capital at maturity. The Committee conclude that UTI, from the time of Chairman Shri G.P. Gupta and Executive Trustee P.J. Nayak, to the tenure of Chairman Shri P.S. Subramanyam again and again tried to convince SEBI that its assured return schemes could not fail, when obviously they could and did. SEBI was skeptical but was unable to persuade UTI to reassess the assurances it was persisting with. Details submitted by UTI (Appendix-XXIII) show that the Executive Committee of UTI met eleven times between January 1997 and December 1998 to approve these schemes in which income distribution as well as capital were assured until maturity. Three officials were members of the Executive Committee throughout this period, Sh. G.P. Gupta (a member throughout this period, first as Chairman UTI and then as Chairman IDBI), Sh. P.J. Nayak (Executive Trustee throughout this period) and Sh. N.S. Sekhsaria (IDBI nominee throughout this period). Besides these officials, Sh. S.H. Khan, former Chairman IDBI, was an IDBI nominee on the Executive Committee for eight of these meetings while Sh. P.S. Subramanyam was a member for two of the meetings, in September and December 1998, after he became Chairman UTI. S/Shri G.P. Gupta and P.J. Nayak kept giving reports to SEBI about the health of these schemes based on erroneous projections, while the Executive Committee kept on clearing new ones. The Committee disapprove these actions and expect a better level of managerial competence from such officials. The episode also highlights the need for all UTI schemes to be statutorily brought under SEBI regulations without any further delay.

#### **I. CONSORTIUM LENDING**

**16.59** Some of the activities of the UTI (as set out under Section 19 of the UTI Act) like granting of loans and advances, accepting, collecting, discounting and re-discounting of bills, etc. are akin to the activities of banks and term lending institutions. Other Mutual Funds are not allowed to undertake such lending activities. The original UTI Act of 1963 did not mention these kinds of business activities but was amended with effect from 1986 to permit them. Similarly, UTI

has the option to borrow from the RBI under Section 20(2) of the UTI Act, a privilege not granted to other Mutual Funds. The participation of UTI in banking and term lending activities do not fit into its mutual fund functions as such investments invariably have long gestations while UTI needs liquid funds to finance redemptions and pay outs in its various schemes. It has been stated by Sh. P.S. Subramanyam, former Chairman, UTI, that, prior to 1986,

“...UTI was not a member of the consortium of financial institutions led by IDBI. The IDBI had organized a forum under the IDBI Act, which is called inter-institutional meeting. Subsequently, in the nineties, IDBI led consortium was joined by the UTI and UTI performe has also taken position. The problem was on the basis of identification of hybrid role for the UTI as a financial institution and mutual fund. The role of the financial institutions also had to be carried out keeping with the desire of the Government that all financial institutions should support and accelerate the process of industrial development in terms of providing debt and equity to industry. At that point of time, the equity market was sluggish. The primary market issues were not succeeding in the market. When it came to UTI, it had to take positions both in equity and term loans to the institutions”.

The current Chairman, UTI, has expressed similar views in so far as the matter related to the dual role of UTI as a mutual fund and FI:

“If we look at the history of the UTI, over a period of time, as the UTI went about its investments there seems to be a clear understanding at all levels—whether it was the borrowing community, the UTI itself or those generally in charge of the UTI—that one of its functions was to participate in consortium lending and to pick up a part of the investment in process. It was over 37 years never a pure mutual fund. Whether it was intended or not, over time, it has got into a lot of investments that a pure mutual fund product would not invest in. The problem started coming when there was a mismatch. A mutual fund, typically, does not have long-term finance with it because in a typical mutual fund people may enter and exit at any time. Therefore, especially if it were a five year closed ended fund like some of our MIPs, it should not be investing in steel projects or projects with long gestation periods, where returns would be available only long after the scheduled date of termination. Over time, the UTI got into this mismatch problem because from the date of closure of the scheme there would not be any returns. So, unless it was always a pure mutual fund, intended to be and understood to be that way, it would not have got into some of these investments. I am not going into the individual investments. It was not intended to be a term lender. The case of financing industrial projects were so large and UTI had sufficient funds at its disposal and on the basis of appraisals done by the IDBI, IFCI and ICICI, the UTI ended up taking a portion of consortium finance. That is the distortion as far as UTI as a mutual fund is concerned”.

The RBI had in a letter dated 1/1/1996 to the Ministry of Finance, expressed its concern about the clauses in the UTI Act which allowed these lending activities and suggested their deletion, a suggestion which has not been implemented till date. Out of the eight cases identified by the Tarapore Committee in which UTI took a fresh exposure in companies whose earlier debts had been classified as NPA's six cases are of consortium financing where additional funds were sanctioned as part of consortium of financial institutions and in five of these cases the additional funds were adjusted against outstanding payments as shown in **Appendix-XXIV**.

UTI started term lending activity in 1986 when the UTI Amendment Bill which was passed in 1986, enabled widening of the business avenues enumerated under Section 19 of the UTI Act by giving powers to the Trust to grant loans and advances apart from a host of other investment activities. Term lending implies medium and long-term loans given by banks and financial institutions and project financing also involves providing finance to projects usually with long gestation periods. Consortium lending was resorted to, in case of large projects, where the

finance was shared by a group of institutions with one institution claiming the role of a lead institution.

UTI was associated with institutions like IDBI, ICICI and IFCI in consortium lending. The Committee have examined IDBI on the issue of consortium financing. The modalities of such financing as finalized in 1976 involved coordination between the principal financial institutions through Inter Institutional Meetings attended by the Heads of these institutions to discuss policy matters and Senior Executives Meetings attended by the other senior executives of these institutions to discuss project proposals, decide upon the lead institution etc. One of the financial institutions would be identified as a lead institution based on its existing expertise in a specific industry and the promoters of a project would deal only with the lead institution even though the project would be receiving funds from the other financial institutions. The lead institution was IDBI, ICICI or IFCI and not UTI because as stated by the Chairman, IDBI,

“...it is an investment institution. The expertise of appraising a project was generally between IDBI, ICICI and IFCI”.

IDBI has also stated that,

“While the consortium approach facilitated collective application of mind, division of labour, uniformity of policy, expedition in sanctions, there was no compulsion on any of the institutions to sanction the assistance”.

IDBI has also submitted details of consortium financing in which it was the lead institution and UTI was a participant. Out of 29 such investments amounting to Rs 1140.3 crore made by UTI, 20 investments amounting to Rs. 927.8 crores were NPA's as on 31.5.2002. Most of these cases were sanctioned during the 80's and early 90's and UTI stopped consortium lending by way of term loans from 1994.

Sh. P. S. Subramanyam has stated that UTI participation in such financing

“...was done as a part of the approach of financing the industrial projects in the country because from the point of view of exposure limits, funds available with only IDBI, IFCI were inadequate to meet with the requirements of the projects...”

Shri Subramanyam also stated that government ministries like the Ministry of Finance and the Ministry of Power organised meetings of the financial institutions to facilitate project closures in infrastructure related projects, as this was a high priority. On its part, IDBI has reiterated that UTI's participation in consortium lending was on its own volition based on its commercial judgment. The Ministry of Finance have informed that there are no records or files to suggest that Government had given any directives to financial institutions or UTI regarding their participation in IDBI or ICICI led consortium financing for infrastructure projects.

UTI started complying with the SEBI provisions and regulations regarding Mutual Funds from 1994, which required it to discontinue term lending activity. Accordingly UTI stopped giving fresh term loans from 1994. However, the restructuring and rescheduling of the earlier project finance loans leading to extension in the term/tenure of finance may have lead to a liquidity mismatch in the wake of fixed maturity periods of UTI's mutual fund schemes which had subscribed to the securities. Also, even though UTI discontinued term lending in 1994, it carried on with project financing and participation in consortium financing by way of subscription to securities like debentures and equity through an informal system of loan syndication instead of the earlier formalized system of consortium financing by All- India Financial Institutions. UTI finally stopped financing new green field projects from 2001.

16.60 The Committee are of the view that the hybrid nature of UTI and the absence of a regulatory mechanism in respect of its transactions, was the source of its problems. The supply of liquid funds to finance redemptions and pay out in various schemes dried up on account of participation in project financing through consortium lending and investments in debentures, all of which required long gestation periods for adequate returns. The overwhelming representation of IDBI on the Board of UTI made it difficult for UTI to act as a pure mutual fund and made it participate in such lending activities that resulted in huge NPA's, low returns and liquidity problems. UTI's activities from the early nineties deviated from the discharge of its functions on sound business principles and disregarded the interests of unit holders. The Committee recommend that UTI be prohibited from undertaking business activities not allowed to mutual funds under SEBI guidelines.

## CHAPTER XVII

### UNIT SCHEME-64

17.1 Started in 1964, the Unit Scheme 64 (US-64) is the first as well as the largest scheme of the UTI. As on 30.6.2001 US-64 had nearly 1.9 crore unit-holding accounts and assets under management (excluding fixed assets) of Rs. 16,509 crore (at cost). In terms of ownership, 99 per cent of these unit-holding accounts belonged to individuals. In terms of investment, individual unit holders held 71 per cent (Rs. 9086 crore) of the total unit capital of Rs. 12,786 crore, while institutional investors held the remaining 29 per cent (Rs. 3700 crore). The importance of the US-64 scheme in the country's capital market can be gauged from the fact that as on 30.6.2001, the UTI with assets under management of Rs. 55,924 crore accounted for 57 per cent of the total assets under management by the entire mutual fund industry; the US-64 scheme on its own accounted for nearly 30 per cent of the UTI's assets under management and around 17 per cent of the total assets under management by all mutual funds.

17.2 US-64 was conceived as an open-ended scheme, allowing investors to enter and exit by buying or selling units at any time of the year. The sale and re-purchase prices of Units in the scheme were announced in July and these prices were progressively increased every month till May of the next year in order to reflect the accumulation of dividend, thus giving a particular return to existing as well as exiting investors and also allowing new investors to enter the scheme. Unlike other mutual fund schemes, the US-64 is not driven by Net Asset Value (NAV) so that the sale and re-purchase price of US-64 units was determined by trend line pricing, not the NAV of the Scheme. The UTI also distributed dividends regularly on the units of US 64. The reserves and dividend payout from the scheme from 1991 onwards is given in the chart in **Appendix-XXV**. If the returns offered in a scheme are based on the NAV (which was not the case with US-64 scheme), it is inherently sustainable, because investors will get a high or low return depending on the market value of the asset on a particular date. From its inception in 1964 till the early 90s, that is, for a good 30 years, prudent investment enabled UTI to sustain its trend line pricing system. However the debt:equity ratio in US-64's investment portfolio, earlier weighted heavily in favour of debt instruments, was dramatically reversed in favour of speculative investment in equity with no proper risk protection measures being put in place. Inevitably difficulties arose and progressively worsened in sustaining the decades-old system of trend line pricing. Instead of reversing the debt:equity ratio, UTI skewed the US-64 portfolio even more in favour of risky equity but without shifting to the NAV basis, notwithstanding the strong recommendations in this regard by the Deepak Parekh Committee. The practice of trend pricing followed in the US-64 scheme, was compounded by a dividend distribution policy that was divorced from the income of the scheme, leading to distribution of dividends by drawing down the reserves. As a result, the reserves of the US-64 scheme turned negative as on 30/6/1998.

17.3 The resulting widespread concern about the loss of confidence in the US-64 scheme due to its negative reserves, prompted the UTI to set up a Committee on 30.10.1998 with Sh. Deepak Parekh as the Chairperson. The committee's mandate was to undertake a comprehensive review of the functioning of the US-64 and to recommend measures for sustaining

investor confidence and strengthening the scheme. In its report submitted on 25/2/1999, the Committee among other things made the following points:

- (i) The popularity of the Scheme in the early years contributed significantly in mobilising savings from the small investors and developing the securities market;
- (ii) The dominant investor share in the Scheme had undergone changes several times over the years reflecting the changes in government tax-policies as well sale-repurchase and marketing policies of the UTI, so that the retail investor in the early years gave way to the corporates in the 1980's and back again to the retail investor in recent years. The unit holding pattern from 1990 to 2001 is given in **Appendix-XXVI**.
- (iii) The dominant role of the scheme and the Trust was lost to the Foreign Institutional Investors (FIIs) in the wake of the economic reform process initiated in the 1990's. UTI and its US-64 scheme had become laggards instead of trend setters by failing to adapt to changes in the external environment;
- (iv) By following trend pricing and a dividend distribution policy of increasing regular returns which had no relation to the NAV or the financial health of the Scheme, the UTI had reinforced the belief in the minds of the investor that the US-64 is an 'almost assured' scheme giving high returns with no perceived risk. This policy had also led to forced sale of blue chip shares and readily marketable fixed income securities, thus exacerbating the imbalance between equities and debt in the Scheme's portfolio;
- (v) In the financial years 1995, 1996 and 1997, the Trust had drawn on reserves to maintain a high rate of dividend;
- (vi) The debt-equity composition of the Scheme's portfolio had undergone a sea change over the years, reversing from a predominantly debt portfolio with a debt to equity ratio of 79:21 in the financial year 1986 to a predominantly equity portfolio with a debt to equity ratio of 37:63 in financial year 1998. Consequently the interest income as a percentage of total income had fallen from 81.3% in FY 1990 to 29.3% in FY 1998 and UTI was forced to book profit by selling its best, most liquid scrips in order to meet the dividend requirements. The percentage of profits booked to total income had therefore increased from 13.1% to 62.5% in the same period.
- (vii) The performance of the equity portfolio, particularly after financial year 1995 had been rather poor. As on 30/11/98 the Scheme had an investment of Rs. 3,689.44 crore in the equity of PSU's constituting 24.3% of its equity portfolio, which represented a fall of Rs. 1,562.56 crore, *i.e.* over 40%, from the acquisition price. While the book value of the equity portfolio had gone up from Rs. 7,942.58 crore in June 1994 to Rs. 13,626.53 crore in June 1998, the market value had actually declined from Rs. 18,377.86 crore to Rs. 10,028.85 crore in the same period. As on 30/11/98, of the equity investments in a total of 1426 companies in the private sector, only 81 companies showed an appreciation while the remaining 1345 depreciated by approximately 47 per cent;
- (viii) The quality of the debt portfolio was also questionable with the gross Non Performing Assets (NPA's) forming 20% of the aggregate debt portfolio and after provisions, net NPA's forming 9.84% of the portfolio;
- (ix) The asset management function of the Trust was highly centralized;
- (x) The UTI was resisting making the Scheme adhere to norms like transparency and disclosure mandated by SEBI guidelines, on the grounds that the US-64 had a 'special characteristic' of a mixed portfolio of assets such as real estate, unlisted debt etc.

17.4 The Committee submitted its report on 25/2/1999; it was accepted by the UTI Board in March 1999 and was made public on 18/5/1999. The terms of reference and the recommendations of the Deepak Parekh Committee are in **Appendix-XXVII**. One of the points highlighted in the report was that a significant portion of the corpus of the US-64 scheme had been invested in the stocks of Public Sector Undertakings (PSU's) during the disinvestment programme of the Government. The Report pointed out that this portfolio had depreciated significantly and had contributed to the decline in the NAV of the scheme and therefore recommended support from the government. On the basis of this recommendation, a Special Unit Scheme (SUS 99) was created in June 1999 by transferring the PSU portfolio of US 64. The PSU stocks had a market value of Rs. 1528 crores but were transferred at their book value of Rs. 3300 crore. The Central Government subscribed fully to the SUS-99 scheme by issuing dated Government securities (carrying an interest of 11.24%) equivalent to the book value of the PSU stocks, thereby providing an implied subsidy of Rs 1772 crores to US-64. On the basis of another recommendation, the initial contributors who held the initial capital of UTI infused an additional sum of Rs 445.5 crores. During the course of its hearings, the Committee noted that certain recommendations of the Parekh Committee were implemented in letter but not in spirit while there were three recommendations that were not implemented at all. Further discussion on the follow up to the recommendations is in para 17.14.

17.5 The UTI Board of Trustees set up a Corporate Positioning Committee on 3.7.2000 with Shri Y.H. Malegam as Chairperson to review the competitive positioning of UTI and to recommend appropriate follow up action to enable UTI to fully meet with the Mutual Fund Regulations of SEBI and enhance its competitive positioning. One of the terms of reference of the Committee was to review the competitive positioning of the UTI in the light of recommendations of the Deepak Parekh Committee. The UTI informed the Malegam Committee that of the 19 recommendations made by the Deepak Parekh Committee 10 recommendations had been implemented, 6 recommendations were in the process of implementation while the 3 recommendations remained on which action remained to be taken. The recommendations on which action had not been taken were:

- (i) US-64 should be NAV driven within three years;
- (ii) There should be a separate Asset Management Company for US-64 with a an independent Board of Directors;
- (iii) The size of the UTI board should be increased to 15, with additional 5 members being co-opted by the Board.

UTI further stated that the implementation of these recommendations would require the amendment of the UTI Act.

17.6 Also, though one of the recommendations of the Deepak Parekh Committee report was that composition of the portfolio needed to be changed to provide for more weight to debt consistent with the aims of the scheme, the ratio of debt to equity in the US-64 portfolio actually fell from 35:65 in June 1999 to 30:70 in June 2000 and further to 25:75 in June 2001.

17.7 The unusually large redemption of US-64 units in April-May 2001 prompted the Board of Trustees to announce the suspension of repurchases in the scheme on 2.7.2001, an event which had never occurred earlier in the history of US-64 scheme, one of the scheme's highlights being its liquidity. There was a public outcry in the wake of which the Finance Minister asked Chairman, UTI to resign for having kept the Ministry of Finance in the dark. These redemptions have been investigated by the High Level Committee to Inquire into the Activities of the Unit Trust of India (headed by Shri S.S. Tarapore) set up by the Ministry of Finance on 26.7.2001 to determine if there was any breach of confidentiality

17.8 The Committee have concentrated their enquiries into UTI's US-64 Scheme on the following issues:

- (i) The declaration of dividends in the US-64 scheme by dipping into reserves.
- (ii) The follow up by the UTI to the recommendations made by the Deepak Parekh Committee regarding US-64 scheme.
- (iii) The unusually large redemption of US-64 units in April-May 2001.
- (iv) The interaction between Ministry of Finance and the Chairman of UTI prior to the announcement of the suspension of repurchases on 2.7.2001.

17.9 In reviewing the actions of the UTI with regard to its dividend distribution policy for the US-64 scheme, the Committee have relied, among other evidence, on the data and analysis presented by the Tarapore committee as one of its terms of reference was to ascertain,

"...the reasons, if these were other than commercial, for the high level of dividends declared by UTI for the US-64 Scheme in the past and the decision to dip into reserves to fund the same."

17.10 Any business entity is expected to distribute dividends from the income it earns in the year and create reserves out of the undistributed income. The UTI Act allows the UTI to create reserves out of the income not distributed to unit holders and utilise these reserves for the benefit of unit holders or for such purposes as the Board of Trustees may determine. In a mutual fund scheme based on NAV, reserves are not in themselves important as they are reflected in the NAV of the scheme and the dividend is also based on the same NAV; at the most reserves can be used to smooth out the year-to-year dividend payouts. However, in a scheme based on administered sale and repurchase prices, as was the case with US-64, the reserves have a special significance, as they are supposed to cover the difference between the face value and the prevailing repurchase price for redemption of the unit. Prudence demands that such reserves should not be used for making dividend payments and should actually be built up so that repurchases do not adversely affect the health of the scheme. Dividend and pricing of units in a scheme like US-64 are linked since the redemption price affects the viability of the scheme as there could be a shortage of reserves to cover the redemption price of units; this provides all the more reason to shun high dividends, specially if they are from the reserves. Considering these factors, the dividend on US-64 units would be deemed to be high

- (i) If the dividend paid was more than the total of income generated in a year and the dividend equalisation reserve, if any,
- (ii) If the dividend paid was not sustainable in subsequent years, and
- (iii) If the dividend payment involved a reduction in reserves to the point that the reserves could not cover the difference between the unit capital and the liability of UTI to unit holders at the redemption price.

Based on these principles, the Tarapore Committee has calculated minimum prudential reserves, which should have been maintained for the US-64 Scheme. The actual reserves and prudential reserves (as calculated by the Tarapore Committee) for the period 1991 to 2001 are in **Appendix-XXVIII**. Dividends were gradually increased from 6.1 per cent in 1964-65 to 19.5 per cent in 1990-91. The rate was further increased to 26 per cent in 1992-93, 1993-94 and 1994-95. During this period, the UTI also provided benefits in the form of preferential and rights offers at concessional prices to unit holders, which added to the liabilities of the scheme.

17.11 The dividends paid in 1991-92, 1992-93 and 1993-94 were generated entirely out of the year's income. According to the calculations done by the Tarapore Committee regarding the level of prudential reserves to be maintained (to meet the difference between the prevailing repurchase price and the face value of the units so that repurchases take place without adversely affecting the health of the scheme), the reserves of the US-64 scheme started falling short of the prudential reserves from 1993-94. If we take only the general prudential norm of declaring dividend from the year's income, the US-64 scheme started violating this from 1994-95 when the dividend distribution of Rs. 3973.25 crore (at the rate of 26 per cent) was 120.9 percent of the net income of Rs. 3287.42 crore. This practice of drawing down reserves to distribute dividends continued in the succeeding years i.e. in 1995-96 and 1996-97 when the dividend distributed was 169.4 percent and 116.2 percent of the net income of the year respectively even though the dividend rate was brought down to 20 percent. In 1997-98 a significant change in the accounting policy was effected in order to allow UTI to declare a dividend. In this year the investment portfolio depreciated sharply by Rs. 3,566.04 crore when comparing the book value to the market value. This would ordinarily have been charged to the 'Revenue Account', thus reducing the US-64 net income of Rs. 3221.59 crore to zero and also reducing the reserves. However, in 1997-98, the accounting policy was changed so that this portfolio depreciation was charged to the 'reserves and surplus' account, thus turning the reserves negative at Rs 1098.49 crore but allowing the scheme to show a positive net income for the year. The Chairman's Statement for the Annual Report of 1997-98 reported:

"There was a sharp decline in equity prices towards the close of UTI's accounting year in 1997-98, which led to an unusual impact on the year-end value of equity portfolio. Considering that this sharp fall in share prices was temporary in nature, the Board of Trustees decided to adjust the consequent depreciation in the value of portfolios against the reserves of the respective schemes. The investors of Unit Scheme 64 were informed that income distribution was made out of net income and the Trust is committed to protecting the interest of its investors."

Subsequently, the dividend was reduced drastically in the period 1998-99 to 2000-01 to 13.5, 13.75 and 10 per cent respectively. The reserves position also improved to 130.2 crore as on 30.6.1999 though this was mainly on account of revaluation of fixed assets (by Rs 543.62 crore) and write back of provisions no longer required for depreciation in the value of investments made in previous years (of Rs. 1290.9 crore). The reserves position improved further to Rs. 3491.7 crore; though a substantial part of the improvement was again the result of write back of provisions (of Rs. 2275.1 crore) for depreciation in the value of investments made during earlier years. Similarly the improvement in the unit premium reserve from negative Rs 819.3 crore as at 30.6.1999 to Rs. 1390.8 crore as at 30.6.2000 was mainly due to Rs. 1763. crore of write back of provision for depreciation in the value of investment made in earlier years. However, all these improvements were again reversed as on 30.6.2001 as the reserves turned negative at Rs. 3676.8 crore due to the depreciation in the market value of the portfolio to the extent of Rs. 6075.6 crore and huge net repurchases at a premium in May 2001, when the repurchase price was high.

17.12 The Tarapore Committee has concluded that there were no extraneous considerations in the dividend policy of US-64 and the reasons for the high dividends were endogenous to the UTI as it was a prisoner of its own pricing policy which was not NAV driven. It has also stated that given the administered price mechanism of the scheme, not having adequate reserves to cover the value of the units at redemption price was a serious error.

**The Committee feel that while the management of UTI must be held accountable for the violation of prudential norms in declaring dividends in excess of income for four continuous**

years from, 1994-95 to 1997-98, especially when reserves were not adequate to cover the value of the units at the administered redemption price, the Ministry of Finance too must bear responsibility for tardy action on the 1993 Vaghul Committee recommendations as well as the 1999 Deepak Parekh Committee recommendations.

17.13 In his deposition, Shri P.S. Subramanyam, the then Chairman of UTI has stated that

“I took over as the Chairman of UTI on 8th September, 1998. I would like to recall the circumstances the UTI had faced. At that time, the US 64 had suffered a high depreciation. It was of the order of around Rs. 3600 crore. The depreciation was there in its investment portfolios. US-64 had also posted a negative reserve which was of the order of Rs. 1098 crore. The reason for depreciation to be adjusted against the reserves was clear. The first task that I had to handle was to present the accounts and get the auditors’ certificate for the accounts before I could present a report. By that time, a dividend rate was 20 per cent had already been declared and paid. Had it been debited to the Revenue Account, it would have become a disputed item resulting in serious qualifications. As I said earlier, the auditors were refusing to sign the balance sheet. There was no other option but to debit the negative reserves to the reserve account which is permitted in the case of the mutual fund industry.”

The current Chairman has stated,

“Ordinarily dividend should be paid out of the surplus generated from operations. In an extraordinary situation, the Board of Directors of a company could decide that if the operating surpluses were inadequate, and there was a good commercial reason to sustain a certain level of dividend, you could take money from reserves to maintain a level of dividend. What would be inexcusable is where a dividend outgo exceeds both the operating surplus, if any, as well as the reserves, which leads to a payment out of the unit capital. If that happens, the unit capital itself gets prejudicially affected and there would be no valid reason for that.”

In the case of the UTI, both prudential norms have been violated, as dividends were declared out of reserves for four years in a row, and in the fourth year, 1997-98, they were actually distributed out of unit capital as the reserves became negative.

17.14 The Deepak Parekh Committee submitted its report on 25/2/1999 and the Board of UTI accepted it in March 1999. The Committee have attempted to gauge the seriousness and dispatch with which the UTI acted on the recommendations of the Deepak Parekh Committee prior to June 2001; while attempting this the Committee have also kept in view the comments made by the Malegam Committee on UTI’s follow up to the Deepak Parekh Committee recommendations. One of the recommendations of the Deepak Parekh Committee (see **Appendix-XXVII**) was that there should be strategic sale of significant equity holdings by negotiation to the highest bidder, whenever feasible.

UTI did not act on this recommendation for a year and it was only on 13.6.2001 that the board of Trustees set up a three member Sub-Committee consisting of the Chairman and two other trustees for the sale of strategic holdings. No such strategic sales have taken place till date.

There were three recommendations regarding reconstitution of UTI Board, which were to increase the size to 15 with five additional members; creation of a separate asset management company for US-64 with an independent Board of Directors and operations of US-64 to be brought under SEBI purview at the earliest.

In response to all three recommendations, UTI stated that they would entail amendments to the UTI Act. The amendment of the UTI Act is being awaited since 1993 when the Vaghul Committee as well as the previous JPC first recommended that the UTI be brought under the purview of SEBI. Another recommendation was that the Inter-scheme transfers should be effected based on independent decisions and requirements of concerned fund managers and at market determined prices. UTI in its compliance note has stated that inter-scheme transfers are being effected at market price as per SEBI guidelines and that such transfers are based on the decisions of fund managers. The facts, however, are that these were not arms length transactions.

**The Committee concur with the observation of the Tarapore Committee that the quantum jump in the inter scheme transfers from/to US-64 in the last three years raises concerns about the bonafides of such transactions and whether they were for window dressing the results of different schemes.**

For example, there were 230 sale transfers from US-64 in December 2000 involving a pay-in of Rs. 3,333.5 crore which were reversed in January 2001 at a pay-out of Rs. 3,447.29 crore, resulting in a net outgo of Rs. 113.80 crore from US-64, to the detriment of the scheme. These transfers, are all the more worrisome as there were no independent arrangements to safeguard the interest of investors in particular schemes so that it is possible that the mechanism of inter-scheme transfers has been used to shift inter-temporal and inter-scheme profits to one set of unit holders at the cost of another set of unit holders. In fact, the entire income for the US-64 scheme for the year 2000-2001 has come from inter-scheme transfers (see **Appendix-XVI**). The current Chairman, UTI, in his deposition conceded that,

“...whatever is available would seem to point to the fact that this was done to boost certain schemes.”

The mechanism of inter-scheme transfers has been discussed in greater detail in Chapter XVI.

17.15 The most significant recommendation of the Parekh Committee was that the US-64 be made a NAV based scheme as that is the only way a mutual fund scheme should be run. The Parekh Committee clearly stated,

“The committee strongly believes that, sooner or later, US-64 will have to become an NAV driven scheme. That is the only way a mutual fund scheme should be run. The Committee is of the view that in the case of US-64, a period of about three years should suffice. By then it should be possible to bring the NAV of the units in line with their repurchase price. The Committee also feels that even if this does not happen, the repurchase price of the units should not remain de-linked from their NAV indefinitely. If, therefore, at the end of the three-year period the two are not in line, the Trust will be left with no alternative but to seek Gol support once again to provide the difference between the NAV and the repurchase price for the units that the Trust would offer at that time. Only a clear commitment from the Gol to stand by US- 64 till it finally assumes the character of a NAV driven scheme will instill the required confidence in the US-64 investors.”

UTI has explained its attempts to implement this recommendation while giving the reasons behind its decision to suspend sales and repurchases in the US-64 scheme as:

- (i) As the Parekh Committee's report was accepted by the Board in March 1999 and the proposal for the creation of SUS'99 scheme to transfer UTI's PSU portfolio was implemented in June 1999, the three year period suggested by the Parekh Committee could be extended to June 2002.

- (ii) Keeping in mind the comment of the Deepak Parekh Committee that exposure of US-64 scheme to the equity of 'the currently fastest growing sectors such as Information Technology, Pharmaceutical and FMCG was negligible', US-64 increased its investments in technology stocks (from 1.2 per cent to 21.7 per cent), pharmaceuticals (from 1.06 per cent to 4.18 per cent) and FMCG (from 4.19 percent to 8.6 per cent).
- (iii) The NAV of the scheme was above par on 28.2.2001 and the UTI expected the NAV to reach somewhere near the sale/repurchase price but the post budget events, the bear hammering and the Tehelka episode severely impacted the market and valuations fell consistently.
- (iv) The scheme's sales were ahead of repurchases till March 2001 so the difference between the repurchase price and the NAV did not have an adverse impact on the financial health of US-64; however due to adverse media reports since April, the scheme faced substantial redemptions in April and May 2001 which coupled with negligible sales and the fall in stock market impacted the NAV of the scheme as well as the market capitalization and the reserves.
- (v) UTI hoped on the basis of its analysis that with the stabilization of the rolling settlement and options system, the volatility caused by the announcement of these measures by SEBI would subside, which along with international and domestic interest rate trends would draw small investors back to the market and improve investor sentiment.
- (vi) The option of immediately linking the sale/repurchase price of the units with the NAV was also considered and it was felt that at that juncture it might cause panic among US-64 unit holders and might ultimately cause tremendous loss to them.
- (vii) UTI at the same time also felt that it would be unwise to maintain the administered pricing at last years rate or at reduced rates because in both events the scheme would have to shell out more money than what it could mobilize; also according to UTI, the long term investors in the scheme might not be able to decide about their continuance or withdrawal from the scheme and would therefore be adversely affected by remaining in the scheme.
- (viii) It was in the light of this that the decision to temporarily suspend sales and repurchases for six months was taken; the justification was that the remaining investors would not have to bear the difference in the repurchase price and the NAV paid to the exiting investors; the unit capital of the scheme would not undergo any change and UTI would get some lead time to for restructuring the portfolio with a view to improving the NAV and making the scheme NAV based in the wake of UTI's expectations of an upward movement in the market.

Subsequently the Board of Trustees constituted a Consultative Group to suggest a limited exit route for small investors; the alternatives suggested by this group were discussed by some Board members with the Ministry of Finance and the UTI at its meeting held on 15.7.2001 approved a scheme for limited repurchase upto 3000 units per unitholder.

17.16 The Malegam Committee in its observations on the follow up by UTI to the Parekh Committee recommendations has stated that the major reason why US-64 had not been made NAV based appear to be

- (a) The substantial gap between the repurchase price of the unit and its NAV which fluctuates according to the market price of US-64's portfolio
- (b) Redemptions take place at prices which are not linked to the NAV and in periods where redemptions exceed sales (e.g in April-May 2001), net redemptions at values in excess of the NAV further widen the gap in respect of continuing unitholders.

- (c) Since the US-64 has large blocks of shares of individual companies in its portfolio, its ability to create immediate liquidity by selling the shares in the market is hampered, as large sales would depress the market and further widen the gap.
- (d) Since the composition of US-64 portfolio has significantly changed with a larger share of equity, UTI's ability to pay dividends is conditioned on booking profits on sale of investments, which further increases the gap.

Given these handicaps, the Malegam Committee has commented,

"It is however unfortunate that the opportunity was not taken to make the scheme NAV based when for a brief period, within the period of three years specified by the Deepak Parekh Committee, the NAV is believed to have been in excess of the repurchase price or in July 2000 when the gap between the repurchase price and NAV is believed to have significantly narrowed."

17.17 Another recommendation of the Parekh Committee was that the composition of the portfolio of US-64 needed to be changed to provide for more weightage to debt consistent with the objectives of the scheme. The ratio of debt to equity in the US-64 portfolio however actually fell from 37:63 in June 1998 to 35:65 in June 1999, 30:70 in June 2000 and further to 25:75 in June 2001 as per **Appendix-XXIX**.

UTI's response on the status of implementation of this recommendation was,

"The portfolio composition of US-64 will have to be gradually reoriented to give more weightage to debt. This will have to be done in a manner in which neither the Trust nor the market will be adversely impacted."

**It is however, inexplicable, how UTI allowed the equity component of the scheme to actually increase in the light of this recommendation. For the debt equity ratio to change so significantly from June 1998 onwards in favour of equity, thereby exposing the scheme to market fluctuations must rank as one of the very disastrous decisions of the UTI Chairman, Executive Committee and the Board of Trustees.**

17.18 The Committee have looked into the heavy redemption of units of the US-64 scheme in April and May 2001. One of the terms of reference of the Tarapore Committee was also to look into the redemptions of units of the US-64 scheme in April-May 2001 and if there was any breach of confidentiality. Repurchases from US-64 (July 1998 to May 2001), distribution of the repurchases between individuals and institutions in April and May 2001, details of redemptions by institutional entities (Rs. 10 crore or more) in April and May 2001 and break up of Repurchases by individual unit holders in April and May, 2001 are given in **Appendices-XXX, XXXI, XXXII and XXXIII**. According to the Tarapore Committee, the inputs in this respect clearly point to the conclusion that the redemptions were triggered by widely shared perceptions and common knowledge which was freely available. The list of institutions which sought redemptions, spread over a wide range, covered public sector banks, financial institutions, public sector units and other corporates. Volatility in purchases/redemptions by institutions has been endemic in US-64 and these were accentuated by the structural weakness inherent in the scheme being operated with administered prices rather than NAV.

The State Bank of India (SBI), which made the largest redemption of Rs. 354.89 crore, during this period had a nominee on the Board of Trustees of the UTI. UTI has also informed this Committee that to meet the redemption pressure during April and May 2001, US-64 had borrowed funds from other schemes to meet its repurchases and UTI had subsequently borrowed

Rs. 400 crore in June 2001 and Rs. 2038 crore in July 2001 from different banks out of which Rs. 1000 crore was from SBI for which discussions were held with SBI on 28.5.2001. The remaining borrowings were from Bank of Baroda, Union Bank of India, ICICI Bank and Syndicate Bank, all of whom had also repurchased their units invested in US-64 in April-May 2001.

When the former Chairman Shri P.S. Subramanyam was asked about the reason for the heavy redemptions in April and May, his reply was,

“Obviously, the banks made their own calculations, and they found that the price quoted in the month of May was higher, and they have redeemed. They stand to benefit. It was triggered by the institutions like ICICI and the State Bank of India itself.”

When asked whether this was on account of inside information, he stated,

“There was no inside information which had gone as such except to the extent that the Board Members, ...were the institution’s nominees or the bank’s nominees in the Board. .... Perhaps, that would have triggered it. I do not want to attribute any motive without doing an investigation into the matter”. He also stated, “Inside information was not there because at that time nobody thought that we would go for a freeze”.

During proceedings before this Committee, the current Chairman was asked about his opinion on the fact that institutions, which were represented on the UTI Board, had redeemed their units in large numbers during this period. His reply was,

“...I am uncomfortable with the fact that people who were present on the Board headed institutions which exited from US-64 in May. I would specially, in the light of a High Powered Committee’s findings, stop short of establishing a casual relationship. But certainly I am uncomfortable with the fact that such institutions exited.”

**All this verbiage cannot hide the fact that the maximum redemption from US-64 was by an institution whose representative sat on the UTI Board. This institutional mechanism raises issues of conflicts of interest, as SBI is a client and a banker to UTI besides being a Trustee of the institution.**

17.19 The heavy redemptions in April-May 2001 were followed by an unprecedented announcement of a total cessation of repurchases in the US-64 scheme for up to six months by the UTI on 2.7.2001. This announcement was subsequently modified to allow repurchases of up to 5000 units at administered prices up to May 2003. The Chairman was removed from his post the next day for having kept not only the UTI Board but also Government “deliberately in the dark”, as the Finance Minister told Parliament. It was this crisis in UTI’s US-64 scheme that led to the reference of UTI matters to the Committee.

The Committee have enquired into the interaction between the UTI and the Ministry of Finance prior to the cessation of repurchases announced by the UTI to ascertain the role the Ministry could have played in averting the crisis. The UTI has a close relationship with the Ministry of Finance. This is evident from the practice of UTI reporting to Parliament through the Ministry of Finance as the UTI has been created by an Act of Parliament; it is also evident from the UTI’s participation in the disinvestment programme of PSU’s through the US-64 scheme and the government’s subsequent bail out package to the scheme by transferring these stocks to itself at book value (SUS-99) even though the market value was much lower; the, current bail out package to small investors in US-64 scheme is further proof of the government’s linkage with the UTI. Further, from 1976 to 1997 an official of the rank of the Joint Secretary in the MoF used to be a nominee on the Board of Trustees by virtue of being nominated by IDBI, a practice that was discontinued from 1/5/1997. This practice has been revived from 21/7/2001 following the crisis in UTI.

When asked about his interaction with Ministry of Finance, Sh. P.S. Subramanyam has stated that it was "As and when required", that the dealing person was the Joint Secretary and the Finance Secretary and that, "They have been kept informed and constantly the presentations also were made before them."

Further, according to Sh. Subramanyam, the Capital Markets Division of the Ministry of Finance had previously asked for information on US-64 itself to which a reply was sent by UTI and followed up by a memorandum presented to the Board of Trustees in April about the strategy to be followed in the case of US-64, which was also furnished to the government although he did not recollect the letter which forwarded the memorandum or whether the memorandum was formally sent to the government. When asked about the contents of this memorandum, Sh. Subramanyam stated,

"Off-hand, I am not in a position to say. But the position was related to the situation of US-64 in terms of funds and the market situation. It was also mentioned that over the years the equity portfolio under the investment of US-64 had gone high and the strategy included three-four different elements. One was to bring down the equity portfolio in the US-64 over a period of time under 50 per cent or even less. Second was to sell the real estates to boost the resources of US-64. Third was also related to the strategic sales which UTI could undertake, where block sales by UTI could be undertaken. There was also a committee appointed by the Trustees including Shri Rajendra Chitale. That committee would look into and advise us how do we go about block sales because UTI itself might not fetch good price unless the buyer gets a big chunk. We had to bring in other institutions like LIC, etc."

Shri Subramanyam also addressed two letters dated 18.5.2001 and 30.6.2001 to the Finance Secretary on the subject of US-64 position and strategy. These letters are at **Appendices—XXXIV** and **XXXV**. Shri Subramanyam has stated that the letter dated 18.5.2001 was sent in continuation to the strategy in the memorandum presented to the Board. The letter does not suggest the cessation of repurchase of units under the US-64 scheme. The letter reviews the status of the US-64 scheme, gives the net income of the scheme as on 17.5.2001 and projects that under the existing stock market conditions the US-64 scheme would be able to give a dividend of 12% as well as maintain a post dividend NAV of Rs. 10 as on 30.6.2001 if the sensex reaches around 4300 level. It further says "there is an expectaiton of about 20-25 per cent raise in the sensex by 30 June 2001". In the Ministry of Finance, the following notations were made in the margin against these two quotes respectively: "?" and "?!!".. The letter is accompanied by an enclosure, which gives the comparative monthly sales, repurchases and net sales position in the US-64 scheme from April 1999 to May 2001.

Shri Subramanyam has stated that he held further discussions with the Ministry of Finance towards the last week of June on the 24th or 25th of June before his second letter dated 30.6.2001 to the Finance Secretary. Shri Subramanyam stated:

"The discussions were held towards the last week, that is on the 24th and 25th of June, if I recollect. That much I remember. This was brought to the attention of the then Joint Secretary, ...and he in turn had brought it to the notice of the Finance Secretary."

When told that this was not quite accurate, as he had met the Joint Secretary on the 29th of June, Sh. Subramanyam stated,

"Before that also, this was brought to his notice. I did meet him on the 29th. That is also true."

When asked to confirm that it was his position that he had met the Joint Secretary prior to 29th June, on the 24th or 25th of June, Sh. Subramanyam has stated,

“I am not sure about the dates. But I do recollect that I had a meeting earlier...”

When asked about the substance of the meeting Shri Subramanyam stated,

“The same continuation of US 64, that is repurchase figures have been higher than the sales and there is a negative liquidity under the scheme. If we have to end up the year, either there has to be some sort of support or we need to manage it ourselves. And consistently, at that point of time, not only during the month of January but even earlier, the Ministry of Finance was of the view that US 64 had to be sorted out by UTI itself without requesting for any financial support from the Government as such...”

Sh. Subramanyam also stated that prior to 30.6.2001, he had told the Ministry of Finance

“...there were three options, if I recollect. One was to go into the usual trend-pricing norm. That means it had no relationship with the basic unit price of US-64. Trend pricing would mean that the closing price of May would become the starting price from July, and there could be a smaller adjustment in that price, which would mean that the gap would be much more higher. So, that was not considered feasible.”

He further added,

“The second was to put it on Rs. 10 basis and then take a stand. The third was to go for a freeze on the re-purchases for a period of six months. At that time, nobody expected that the incidents of 11th September and 13th December would happen. We thought that the markets would improve and it would be possible by the end of the year, we would be able to break even under US 64 and that would coincide with the last period within which the US 64 was to go into the net asset value mode, that is well before February 2002... So, it was combined on that basis, dovetailed with the commitment which UTI had undertaken that US 64 would be brought under NAV mode by February 2002.”

17.20 Sh. Subramanyam has also stated that when he met the Joint Secretary on the 29th June,

“...I requested him that he should apprise the Finance Secretary. I also requested him that if that is possible, he should apprise the Finance Minister as well...”

He further stated that he followed up this meeting with his letter dated 30.6.2001. In this letter addressed to the Finance Secretary, Sh. Subramanyam refers to his letter dated 18.5.2001 and “... the subsequent discussion I had with you on the subject.”

When asked to confirm that this discussion was prior to 30th June, and that this was the one on June 24th or 25th with the Finance Secretary and not the one with the Joint Secretary on the 29th of June, Shri Subramanyam stated that generally he used to meet the Joint Secretary and then call on the Finance Secretary and that he had briefed both about the impending decision and that the discussion he was referring to in his letter was this discussion on the 24th or the 25th and not the discussion of the 29th June.

On being asked why he did not think it necessary to question the two assumptions on which the Chairman had predicted the viability of US-64—namely a rise in the sensx of 20-25 percent

and a sensex level of around 4300 by end June—Hon'ble Shri Yashwant Sinha, who was Finance Minister at that time, said:

"When I looked at the assumptions in the letter, there was nothing fairly dramatically unusual about it."

The Committee asked the former FM, whether he was concerned about the impact on UTI generally and on the liquidity of US-64, in particular, of the crash in the stock market. The Minister replied,

"I had stated in the Rajya Sabha that when I saw the Press reports during the month of May and June that all may not be well with the UTI and US-64, I made enquiries about the situation. I mentioned this to the then Finance Secretary and suggested to him from time to time that this matter should be enquired into from the UTI management and we should find out as to what exactly was the situation. I also said that Rajya Sabha that I was assured repeatedly—not once or twice, but whenever I made such enquiries—that the management of the UTI had been contacted and the Ministry had been assured that they were capable of dealing with the problem and that there was nothing really wrong."

In answer to another question, former FM stated:

"....I did come across such news reports. They not merely related to K-10 stocks and all that but they also related, for instance, to large redemptions from US-64, especially in the month of May. These reports did disturb me and when I said that I made enquiries and told the then Finance Secretary that he should find out what was happening to the UTI—I also made a statement in the Rajya Sabha—this is what I meant, that I came across news reports. And every morning when I read those reports, I went to the Ministry and asked the officers to find out what was happening. Also additionally the point that I was making was that every two or three days, suppose for instance I read a report today and three days later I read another report and I made inquiries, and three days later they will say, 'We made enquiries about the earlier report and we have been told by the UTI that there is nothing to worry.' So, this was the kind of enquiries that one was making; one was aware of such reports appearing in the pink papers and other papers. It was not that I ignored them, I did make enquiries."

Responding to queries as to whether, in the light of the experience of 1998, it was not the duty of the Capital Market Division in the Ministry to have periodically reviewed the net asset value and UTI's redemption liabilities and whether UTI's autonomy absolved the Ministry of its responsibility, the former FM replied:

"We pro-actively pursued this question of the health of the US-64."

On then being asked "Still you remained in the dark?", the former FM responded:

"It is because repeatedly we were told by the UTI that there were no problems."

Regarding the contents of the Chairman's letter of 18 May 2001, former FM said:

"It is incumbent on the Ministry to examine it and put it up."

However, this was not done.

As the Ministry of Finance had not informed the Committee of any interaction on US-64, with UTI between Chairman, UTI's letter of 18.5.2001 and 29.6.2001, and both Finance Secretary and Joint Secretary (CMD) had denied having met chairman, UTI on or around 24.6.2001 (as set out

in paragraph 17.21) below, the Committee asked MoF to make available the file relating to interaction between MoF and UTI in the year 2001, particularly the period from April to June. As MoF said they had no file on the subject, the Committee asked that it be provided with the folder or file in which the original copies of chairman, UTI's letters of 18.5.2001 and 30.6.2001 are preserved upon which MoF furnished file no. 7/31/CM/2001 in two volumes, (A) and (B).

The file is in the usual two sections: notes and correspondence. The first noting in file A is by Joint Secretary (CMD) and is dated 2.7.2001, that is the day FM met chairman, UTI. There is nothing in the notes section of the file prior to that date recording any interaction between the Ministry and UTI before 29.6.01. Indeed, it is clear from the note of Dir. (CM) at pp. 4-5 that the file itself was constituted and given a number only on or after 4.7.01. The correspondence part of the file is not arranged date-wise. The letter at page one of the correspondence section is dated 14.7.2001. The faxed copy of Chairman, UTI's letter of 18.5.2001 is placed at page no. 37-40 indicating its insertion at a date subsequent to the date of the first opening of the file. Chairman's letter of 30.6.2001 is at page no. 41-45. While the chairman's letter of 30.6.2001 is summarized and commented upon in detail by the officers concerned, with respect to chairman, UTI's letter of 18.5.2001 there is no summary, assessment or analysis of that communication in the notes or correspondence section of the file (apart from the notations on the body of the main letter, it is surmised that the partially legible comment on the enclosure to the letter referred to in the previous sub-paragraph is on the original copy (not in file) and not in the faxed copy at pages 37-40). Chairman, UTI's letter of 18.5.2001 was put up to FM as an FR for information but FM's orders were neither sought nor given, notwithstanding FM's testimony that it was incumbent on the Ministry to examine the letter and put it up to him. The second volume of the file contains a detailed note from JS (CMD) prepared on 16.7.2001 a fortnight after UTI froze redemptions, referring to press items which were critical of the Ministry for not fulfilling its role. The note details action taken by the Ministry along with photocopies of relevant notings from other files, which according to the JS (CMD) would prove that the Ministry did understand the gravity of the situation in time though it did not know the precise data about US-64, which only the UTI management/Board could be expected to know. The file contains a noting from another file, which mentions that the Finance Secretary had been asked by the Finance Minister on 18.5.2001 to let the Ministry have an up to date picture of the current status of UTI. But there is no indication of any further interaction between the UTI and the MoF on this issue except for the faxed letter of the same date, 18.5.2001, which has been placed in volume A.

About his meeting with the Finance Minister, Sh. Subramanyam has stated that he met the Finance Minister on the 2nd July, i.e. on the day that the meeting of the Board of Trustees was to take place. The meeting according to Sh. Subramanyam was in the morning at 10:30 a.m. and lasted for about five minutes. According to Sh. Subramanyam, he briefed the Finance Minister about the current situation and also mentioned that the Finance Secretary was of the view that the UTI "...should take the decision on ourselves." The Finance Ministers response according to Sh. Subramanyam was to advise him to go ahead with his meeting. Specifically, Shri Subramanyam has stated that neither did the Finance Minister dispute nor did he endorse what was informed to him and the impression he got was that in the Finance Minister's view, the decision was left to the Board. The Committee have noted that on one hand Shri Subramanyam has stated that he had kept the government informed about the impending crisis in UTI prior to 30.6.2001, while on the other his letter of 18.5.2001 to the Finance Secretary states that the current NAV of the scheme is Rs. 9.50, he expects the scheme to earn an income of 12 per cent by 30.6.2001 and is quite sanguine about declaring a dividend of 12 per cent and maintaining a post dividend NAV of Rs.10. He also compares favourably the yield of 8.89 per cent based on a July 2001 dividend of 12 per cent and sale price of Rs. 13.50 with other similar instruments in the market.

17.21 The Ministry of Finance, on its part, in response to a question, has stated that there is no practice of the UTI sending monthly reports to the Ministry. There is a provision that UTI would submit a half-yearly audit report on the performance of the Special Unit Scheme, 1999 portfolio as the government, as a consequence of the Deepak Parekh Committee recommendation has provided Rs 3300 crore worth of government bonds to the UTI in exchange for the portfolio of PSU stocks previously held by US-64, and now transferred to SUS 99. When the Finance Secretary (Shri Ajit Kumar) was asked when the Chairman of UTI met him in June 2001, and whether he had met him between 25th June and 30th June, his reply was that he would have to go back and check because what generally happened was that the person wishing to meet him sent a chit and he would meet them if he was free. According to him the previous specific appointment sought was in November 2000 and regarding June 2001, he would have to check up. Subsequently, the following reply was received from the Ministry of Finance, "As per the record of engagement diary of the then Finance Secretary (Shri Ajit Kumar), Shri Ajit Kumar, the then Finance Secretary did not meet the then Chairman, UTI in the month of June 2001, specifically between 25th June and 30th June, 2001." There is therefore an obvious discrepancy between the version of events as related by Sh. Subramanyam and Sh. Ajit Kumar. The Committee doubt that Shri Subramanyam met the Joint Secretary or Secretary on June 24th or 25th. On his part, the Joint Secretary has stated that the last time the Chairman of UTI met him was on the 29th of June, when, "In the evening he walked in without any prior appointment". When the Joint Secretary was asked whether the Chairman had asked for any appointment with the Minister of Finance or the Finance Secretary, his reply was, "Sir, I am not aware of his request for a meeting with the Finance Secretary or the Finance Minister. But he did discuss UTI's affairs and I gave him my advice as an individual because he had not come for seeking any formal clearance of any sort or any formal reaction from the Government...". The Joint Secretary has also sent a note to the Committee in which he has given his recollection of what transpired between him and Sh. Subramanyam during their meeting on 29th June, 2001. In this he states,

"On 29 June, 2001 (Friday), late afternoon chairman UTI called on JS (CM) informally (there was no prior appointment). Chairman, UTI stated that their Board would meet on 2nd July, 2001 (Monday) in New Delhi and that they were considering two options:

- (a) to freeze US-64 redemptions; and
- (b) to convert US-64 to a NAV basis.

2. Chairman UTI was advised that I had no authority to give any comments and that it was, in the first instance, for UTI's Board of Trustees to take a view in the matter. Chairman, UTI was asked whether UTI was sure that these were the only two options available and whether they had done their homework thoroughly. Further, he was told that, purely from a professional point of view and not as a Joint Secretary in the Ministry, my suggestion for them would be to go to NAV. Chairman, UTI was also advised that all concerned should be immediately informed in writing, if they have not done so already. Finance Secretary was fully briefed about this conversation on the same evening i.e. 29 June, 2001 (Friday)."

**17.22 The Committee note that the Finance Minister has testified that he repeatedly asked his officers to be in touch with the Chairman, UTI, about the position of UTI/US-64 in the post-stock market crash period. There is, however, a reference in F. No. 7/31/CM/2001 (B) to a note recorded by a Dy. Director (CM) dated 17.5.2001 relating to a news item captioned "UTI hasn't bailed out Parekh stocks" appearing in the Times of India of the same date. In respect thereof, the Secretary Finance has recorded the following on 18.5.2001:**

"As desired by FM, I have today asked Chairman UTI to let us have an up to date picture of the current status of UTI. Let us await his report."



Chairman, UTI's letter of 18.5.2001 was not examined by the Ministry, the officers concerned having merely put up the letter to the Minister as an 'FR' (Fresh Receipt) for information without analysing its contents on file either before or after submission to FM. There also appears to be no evidence to suggest that there was any meeting or consultation between Chairman UTI and Ministry of Finance officials between his letters of 18.5.2001 and 29.6.2001. Therefore, while Chairman UTI did keep the Ministry in the dark up to 29.6.2001, the Committee find that despite repeated directives from the Finance Minister to his officials from April 2001 on to find out what was happening in UTI, the officials, as they have informed the Committee, limited their interaction with UTI to Chairman, UTI's letters of 18 May and 30 June 2001. No analysis was made in the Ministry on the Chairman's letter of 18.5.2001 and the letter itself was treated as an 'FR' (Fresh Receipt) requiring no more than perusal without analysis or follow up. The Minister told the Committee that he was concerned about the impact on UTI of various adverse developments in capital markets and had instructed his officials to find out the facts from UTI, the report the Ministry got from the Chairman UTI was that everything was under control. Even if Chairman, UTI did indeed keep everybody in the dark, as FM told the Rajya Sabha, the Committee find the Ministry did little to bring itself out of the darkness, as it had not instituted any formal mechanism to keep itself informed about the health of the US-64 scheme. Autonomy in day-to-day management of UTI cannot absolve the Ministry of its statutory responsibilities and accountability to Parliament.

17.23 On 29.6.2001 Chairman UTI met with Joint Secretary, Capital Market Division. The meeting was unscheduled and without any prior agenda and there was a discussion on the impending problems of UTI. Thereafter, the JS discussed this subject with the Finance Secretary but no further action appears to have been initiated by the officials of Ministry of Finance. A letter was received from Chairman UTI by Secretary, Ministry of Finance on 30.6.2001 in the evening at his residence, which clearly stated that the UTI Board would meet on 2nd of July and they were considering two options, viz., either

- (i) to freeze US-64 redemptions; or
- (ii) to convert US-64 to NAV basis.

Quite obviously this was a very important piece of news and the Finance Secretary should have acted immediately. Indeed, Finance Secretary Shri Ajit Kumar's action should have commenced immediately after discussion on this subject with the Joint Secretary on 29.6.2001. He could have tried to evolve methods to avoid redemption crisis and also discussed the matter with the Finance Minister immediately. The Secretary mentioned this fact to the Finance Minister only on the morning of 2.7.2001 after the weekend was over. Particularly after receiving a formal letter from Chairman UTI on 30.6.2001 indicating the two options to be placed before the Board of Trustees, taking no action to immediately discuss the matter with the Finance Minister or find solutions to the serious problem that could arise consequent to the Board meeting on 2.7.2001 shows that the Secretary considered the problem in a routine and casual manner which is not expected from an officer of his rank.

## CHAPTER XVIII

### ROLE IN THE CALCUTTA STOCK EXCHANGE PAYOUT CRISIS

18.1 The genesis of the payout crisis, which occurred in the Calcutta Stock Exchange (CSE), on 8.3.2001 and 9.3.2001, has been discussed in detail in Chapter VI, Part I of the report. This chapter is confined to discussing the role of the UTI in the direct purchase of the shares of DSQ Software from the CSE. The CSE offered these shares for sale to UTI as the broker members who had previously ordered them, did not have the funds to pay the CSE to take delivery of these shares on the payout date.

18.2 On 8.3.2001, (which was the settlement date for the trading that took place on CSE between 23.2.2001 and 1.3.2001—Settlement no. 148), some member brokers of the exchange failed to meet their payment obligations for the purchases previously made by them. The members of the Governing Committee of CSE decided on 9.3.2001 to find other buyers for the shares of the defaulting brokers Sh. Harish Chandra Biyani and Biyani Securities. These were 28.42 lakh shares of Himachal Futuristic Communications Ltd (HFCL) and 13.30 lakh shares of DSQ Software India Ltd. The CSE offered these shares to UTI in an off market deal and the UTI confirmed the purchase of 13.30 lakh shares of DSQ Software @ Rs. 189/- per share for a total consideration of Rs. 25.13 crores at a 10 per cent discount to the market rate of Rs. 210 per share. These purchases were made in a falling market for DSQ Software shares. The price of the scrip as on 28.6.2002 was Rs. 28.10, which represents erosion in value of Rs. 160.90 per share (85.1 per cent) and a total erosion of Rs. 21.40 crore on a transaction of Rs. 25.13 crore over a period of sixteen months. The principal persons involved in this transaction were Shri P.S. Subramanyam, the then Chairman UTI, late Shri M.M. Kapur, the then Executive Director UTI who was in charge of both the US-64 scheme as well as dealing room operations, Shri B.G. Daga, the then Executive Director UTI who was also SEBI's public nominee on the Board of CSE and Shri Kamal Parekh, the then president of CSE.

#### A. TARAPORE COMMITTEE'S REPORT ON THE TRANSACTION

18.3 As one of its terms of reference, the Tarapore Committee was asked by the government to enquire into UTI's involvement, if any, in the Calcutta Stock Exchange payout crisis in February–March 2001.

On the basis of material submitted by the UTI, the Tarapore Committee has pieced together the following sequence of events:

- (i) On 9.3.2001, Shri Kamal Parekh, the then President of the Calcutta Stock Exchange, sent a fax message to the late Shri M.M. Kapur, Executive Director, UTI, offering to sell 25.41 lakh shares of Himachal Futuristic Communications Ltd. and 13.30 lakh shares of DSQ Software directly to the UTI at the then prevailing market prices. The letter (dated 9.3.2001) was faxed to the UTI, and as the letter was incomplete, faxed again in the afternoon of 9.3.2001. In a third fax to Shri M.M. Kapur immediately thereafter, Shri Kamal Parekh clarified that the earlier fax had some typographical errors and confirmed that the offer for sale of shares in the second fax was correct. The price

at which shares were being offered by the CSE was, however, not stated in any of these faxes. There is also no record of any noting in the UTI relating to these letters. A fourth letter was faxed from Shri Kamal Parekh to Shri M.M. Kapur, within 21 minutes of the earlier offer in which there was a reference to a telephonic conversation with Shri Srinivasan of the UTI confirming the finalisation of the deal for sale of 13.30 lakh shares of DSQ Software at Rs. 189/- per share. The first noting in the UTI (dated 9/3/2001) is on this letter, disclosing that the UTI had already bought 13.30 lakh shares of DSQ Software at Rs. 189/- per share and that the shares may be allocated to US-64. Shri M.M. Kapur approved this noting. The Statement of Orders placed for the day (9/3/2001) included the purchase of 13.30 lakh DSQ Software shares and this was signed by both the Executive Director and the Chairman of the UTI on the same day. The purchase of 13.30 lakh shares of DSQ Software at Rs. 189/- per share for a total consideration of Rs. 25.13 crore was reported along with other transactions in a Memorandum placed for information of the Board of UTI at its meeting held on 26.4.2001.

18.4 In a note submitted to the Tarapore Committee the UTI stated that:

“The then ED (US-64/Dealing) reportedly after consulting the then Chairman decided to accept the offer of CSE in respect of DSQ Software. The exact details of the consultation process were not known.

As advised by ED (US-64/Dealing), 13.30 lakhs of shares of DSQ Software Ltd. were bought for US-64 @ Rs. 189/- per share, which was approximately 10% lower than the day's closing price of the scrip on CSE. The same was reported back to ED immediately after closing the deal as per his instructions by means of an internal noting on the CSE's confirmation letter itself.”

18.5 In a note sent by Shri B.G. Daga, Executive Director to Shri D.S.R. Murthy, Executive Director dated July 24.7.2001, the purchase was explained by stating that:

“Although it is not mentioned in the letter from CSE President, it may be noted that the offer was made to complete the payout of settlement No. 148 of CSE, as certain brokers who were to receive these shares in payout had failed to pay in money. Therefore, CSE decided to sell the shares to raise money to complete the payout. Out of the 2 scrips offered to UTI, UTI decided to buy 13.30 lakh shares of DSQ Software. Although papers in the file do not contain any note in respect of this particular offer, it is observed from the records that during the preceding 3 months, the Trust had sold DSQ shares as under:

	Month	Number of shares	Average Price (Rs.)
1.	December 2000	15,000	443.43
2.	January 2001	2,46,200	393.32
3.	February 2001	2,65,001	418.91

The shares were bought at 10% discount to the then closing price of Rs. 210/- i.e. Rs. 189/- per share.

The deal was between CSE and UTI and not between any particular broker and UTI. In the past also, there would be some occasions when UTI had bought shares directly from the stock exchanges to enable them to complete their settlements.”

18.6 The Tarapore Committee has stated that there was no contemporaneous written record regarding the processing of this purchase transaction. This indicated that it was a mere formalisation of a decision already taken for which there were no records available. Although the UTI note to the Tarapore Committee indicated that the exact details of the consultation process was not known, Shri Daga's note of 24.7.2001 did indicate that the letter of offer from the CSE was in the background of the CSE pay, in crisis. The UTI was not, however, able to trace any past cases, which would validate Sh. Daga's claim that in the past, there would be some occasions when the UTI had bought shares directly from the Stock Exchanges. UTI's holdings of DSQ Software as on 9/3/2001 were 18.07 lakh shares. This fell to 16.70 lakh shares as on 30.6.2001 and the sales in this period were undertaken at very low prices ranging from Rs. 84.93 and Rs. 133.79. The note of 24.7.2001 by Shri Daga, however, did not refer to UTI's sale of DSQ Software shares after its purchase from the CSE on 9.3.2001 and therefore, his implicit assertion regarding sales at relatively favourable prices in December 2000-February 2001, gave a distorted picture of the UTI's transaction in DSQ Software shares. Specifically, by 24.7.2001 (the date of Shri Daga's noting), prices of DSQ Software had fallen precipitously and trading volume had become extremely thin. Thus, between 23.4.2001 and 23.8.2001, UTI sold 4.54 lakh shares of DSQ Software at prices ranging between Rs. 28.71 and Rs.133.79 at a weighted average price of Rs. 55.78 per share. By the time of Shri Daga's note of 24.7.2001 the UTI had already contracted sales of DSQ Software shares at prices as low as Rs. 49.38 per share on 18.7.2001, a fact that was not mentioned at all in his note of 24.7.2001.

18.7 The Tarapore Committee made the following comments about this transaction of the UTI with the CSE:

- (i) It was an off market purchase transaction which did not involve normal scrutiny and process of decision-making. The concerned Executive Director, apparently in consultation with the then Chairman, UTI took the decision and no other person appeared to have been involved in the decision-making process. The matter was also not specifically placed before the Board as an unusual transaction, but only reported as a routine information item on transactions.
- (ii) The share price of DSQ Software had been declining almost continuously from the end of June 2000 when the price of the scrip was Rs. 950.35 at BSE and Rs. 933.95 at NSE. The price of the DSQ Software scrip had plummeted by as much as 60 per cent between end of June 2000 and the end of February 2001. This decline was much sharper than the decline of 10.6 per cent in the BSE Sensex and 28.4 per cent in the BSE IT Index (which comprises select IT scrips) during the same period. The price of DSQ Software had declined almost continuously, and, on many occasions, touched the lower circuit breaker of 16 per cent in the month of February 2001 and the first week of March, 2001, *i.e.* just before the purchase transaction. Of the 25 trading days prior to the deal with the CSE, the price declined on 16 trading days at BSE; on one occasion, the decline was 16 per cent, and on three other occasions, the decline was 10 to 11.8 per cent. On the day of purchase itself, the price had fallen by 16 per cent. That the price of the scrip had declined very sharply and the decline was much sharper than the decline in share prices in general, and IT stock prices in particular, suggested that DSQ Software was problem scrip. Thus, the 10 per cent discount over the market price negotiated by UTI on the day of the transaction was clearly inadequate and was more than wiped out the very next day after the transaction, as the price of DSQ Software declined by 16 per cent. In fact three days after the purchase was made, the price of the scrip had fallen by as much as 40.6 per cent on the BSE to Rs.125.95. The closing price of the scrip on September 20, 2001 was Rs. 42.90, which represents a depreciation of Rs.146.10 or 77.3 per cent per

share and a total depreciation of Rs.19.43 crore on the transaction with the CSE of Rs. 25.13 crore.

- (iii) A team of officials from the Equity Research Cell (ERC) of the UTI who visited DSQ Software in July 2000, had submitted a report in September 2000 in which they recommended that short term upsides in the stock market be used as an opportunity to reduce UTI's exposure to the company. The UTI entered into the transaction with the CSE despite the ERC recommendation. By this one single transaction of 13.30 lakh shares, the UTI significantly increased its exposure to DSQ Software. The purchase transaction was more than twice the total sales of 5.26 lakh of DSQ Software put through by the UTI between December 2000-February 2001. As on 8.3.2001, the UTI held 4.77 lakh shares of DSQ Software in the US-64 portfolio and the purchase of 13.30 lakh shares on 9.3.2001 increased the UTI's exposure substantially in a falling market.

**Table : Month-end Prices of DSQ Software at BSE and NSE**

Month-end	Price at BSE	%change over the previous month	Price at NSE	%change over the previous month	BSE IT Index	%change over the previous month	BSE Sensex	%change over the previous month
1	2	3	4	5	6	7	8	9
Oct.-99	297.75	12.4	295.70	15.2	1865.25	-9.9	4444.56	-67
Nov.-99	451.50	51.6	444.15	50.2	2443.01	31.0	4622.21	4.0
Dec.-99	833.00	84.5	853.50	92.2	3944.84	61.5	5005.82	8.3
Jan.-00	1320.00	58.5	1329.10	55.7	4694.31	19.0	5205.29	4.0
Feb.-00	1651.00	25.1	1649.90	24.1	6637.63	41.4	5446.98	4.6
Mar.-00	1630.00	-1.3	1667.70	1.1	5749.37	-13.4	5001.28	-8.2
Apr. 00	890.00	-45.4	891.00	-46.6	4044.25	-29.7	4657.55	-4.8
May-00	701.15	-21.2	697.90	-21.7	2954.76	-26.9	2233.61	-48
Jun.-00	950.35	35.5	933.95	33.8	3840.97	30.0	4748.77	7.1
Jul.-00	626.65	-34.1	612.80	-34.4	3116.31	-18.9	4279.86	-9.9
Aug.-00	769.05	22.7	746.50	21.8	3894.97	25.0	4477.31	4.6
Sep.-2000	519.70	-32.4	521.50	-30.1	3273.62	-16.0	4090.38	-8.6
Oct.-00	369.35	-28.9	365.10	-30.0	2964.09	-9.5	3711.02	-9.3
Nov.-00	453.30	22.7	457.60	25.3	3024.52	2.0	3997.99	7.7
Dec.-00	392.75	-13.4	392.90	-14.1	2655.81	-12.2	3972.12	-0.6
Jan.-01	419.85	6.9	420.90	7.1	3063.44	15.3	4326.72	8.9
Feb.-01	373.95	-10.9	373.65	-11.2	2748.52	-10.3	4247.04	-1.8
Mar.-01	98.15	-73.8	98.55	-73.6	1602.16	-41.7	3604.38	-15.1

1	2	3	4	5	6	7	8	9
April-01	95.50	-2.7	94.85	-38	1578.35	-1.5	3519.16	-2.4
May-01	95.60	0.1	95.25	0.4	1732.87	9.8	3631.91	3.2
Jun.-01	60.40	-36.8	60.45	-36.5	1484.85	-14.3	3456.78	-4.8
Jul.-01	40.65	-32.7	40.30	-33.3	1407.71	-5.2	3329.28	-3.7
17-Aug.-01**	—	—	38.05	-56	1400.24	-0.5	3296.71	-1.0
Aug.-01	—	—	44.00	15.6	1393.61	-0.5	324.95	-1.6
20 Sept.-01**	42.90	5.5@	42.95	-2.4	931.23	-33.2	2761.66	-14.9

\*\* Trading in DSQ Software which was suspended both at BSE and NSE from August 2, 2001, was resumed at NSE on August 17, 2001 and BSE on September 10, 2001.

@ Variation over end-July 2001.

18.8 The Tarapore Committee also sought SEBI's assistance in connection with UTI's involvement in the CSE payout crisis asking for inputs about its assessment of the problem, and any correspondence, internal notes/submissions made to external agencies/authorities by SEBI on this matter. In their response, SEBI merely forwarded a copy of the letter dated 13.7.2001 by Shri P.K. Ray, Secretary, Calcutta Stock Exchange addressed to Shri S. Ravindran, Deputy General Manager, SEBI which reads:

"Kindly refer to the telephonic discussion you had with the undersigned this afternoon regarding purchase of 13.30 lakhs equity shares in DSQ Software Ltd. by Unit Trust of India.

In this connection, we would like to submit that a spot deal over telephone was entered into with UTI on the night of Friday, the 9th March 2001 by Sri Kamal Parekh, the then President of the Exchange.

The Exchange had received Rs. 25,13,70,000/- (Rupees Twenty Five Crores Thirteen Lakhs Seventy Thousand) through cheque No. 346003 on UTI Bank Ltd. towards the consideration for the aforesaid sale on Monday, the 12th March 2001 and the same was encashed by the Exchange on 13th March, 2001."

18.9 Based on its enquiries, the Tarapore Committee concluded that:

- (i) UTI was involved in the CSE payout crisis of February-March 2001. The transaction raised some critical issues, which were not fully clarified from the documents/notings submitted by the UTI and by SEBI.
- (ii) UTI's purchase of DSQ Software was not triggered merely by the cryptic offer to the UTI in the letter of 9.3.2001 faxed by the then President CSE. The transaction was not transparent and was not subjected to the discipline of normal decision-making processes and procedures of the UTI. It could not be justified on commercial considerations. Although the shares were purchased at 10 per cent discount to the closing price at CSE on the day of the transaction, in a sharply falling market, the discount was not sufficient to protect the unit-holders' interests as the scrip had virtually lost liquidity. The existing holding of the scrip by the UTI was already jeopardized, and buying further into the stock, was not in the interests of the UTI. The bypassing of all

prudent processes by the UTI could not be justified even if it was to be considered as a White Knight action to help the CSE. Even if the transaction was undertaken on other than commercial consideration, it was incumbent on the UTI management to handle this transaction in a transparent manner and with full details ratified by the Board as to the justification for recourse to a non-commercial transaction and the imperatives for this transaction. The transaction violated the mandate of the UTI.

- (iii) The material provided to the Committee did not provide a complete picture and a number of issues needed to be followed up such as who profited by the transaction i.e. who is most likely to have brought it about and to what purpose. However, the Tarapore Committee concluded that this issue was beyond its terms of reference.

18.10 As the Tarapore Committee concluded that certain issues raised by the transaction were beyond its terms of reference and also beyond the mechanisms available to it, it recommended that the issues relating to the CSE transaction of the UTI should be addressed exhaustively in a holistic examination by appropriately empowered bodies. It also recommended that the UTI should always undertake transactions in the best interests of its unit holders, the charter of the UTI should be respected and the UTI should not be expected to participate in such bail-outs which harmed the interests of its unit holders.

## **B. DEPOSITIONS BEFORE THE COMMITTEE ON THE TRANSACTION**

18.11 The Committee has examined Shri P.S. Subramanyam, the then Chairman of UTI on his role in the decision to purchase these shares from CSE. He denied any prior knowledge about the transaction. He stated that, "Soon after the stock market crashed after the Budget presentation, in the first week of March, reports had appeared that the CSE was probably facing payment difficulties. And SEBI had mentioned that CSE would have taken the necessary margins and the difficulties may be of a temporary nature. That was the time when—this, I came to know late—the President of the CSE had a direct dialogue with Mr. Kapur, the Executive Director and offered to him certain shares, including DSQ for direct purchase without the involvement of any broker. These were the shares held by the CSE apparently as margin. Those shares were sold from the CSE directly to the UTI." He further stated that, "I came to know of it after the transaction had been put through. There was no prior approval, which was obtained." On two other occasions during the proceedings, he stated that, "It was related to secondary market operation because it was purchased from the CSE. There was no prior approval which was obtained from me" and "It was not with a prior approval; it came to my notice later on." He also accepted that on hindsight, perhaps UTI should have obtained a higher margin. Shri P.S. Subramanyam also expressed the opinion that the two Executive Director's were party to the decision. "I remember another ED Shri Daga joined the issue saying some such instances had happened in the past. He was a Member of the Calcutta Stock Exchange as a public representative appointed by SEBI. He was the Executive Director of the UTI. He had gone there for attending the meetings of Calcutta Stock Exchange. He had obtained permission to go, for travel as such. So, perhaps there might have been a dialogue between the two Executive Directors, the ED of UTI and the ED, Shri Daga who happened to be the SEBI nominee on the Calcutta Stock Exchange." On being asked with whom Sh. Daga might have discussed the transaction, Shri P.S. Subramanyam stated, "Shri Kapur might have had discussion with him. Both were Executive Directors." He also expressed the opinion that, "Probably SEBI might have been consulted on this issue."

The current Chairman, UTI informed the Committee on 4.4.2002 that UTI had commissioned an internal inquiry by its Chief Vigilance Officer to investigate the circumstances in which the UTI bought the shares of DSQ Software directly from the CSE and that the report would be available in the next one week. He also stated that the enquiry officer had recorded the

statements of all the concerned people related to UTI but there were persons who were outside its ambit. It was informed the departmental enquiry had been conducted on directions received from the Ministry of Finance *vide* their letter dated 28.1.2002 and that UTI was going to make this report available to the Government for further action. The departmental enquiry report of 5.4.2002, the Memorandum of the Board of Trustees that had considered the report in its meeting held on 11.4.2002 and copy of letter dated 12.4.2002 forwarding these documents to the Ministry of Finance were submitted to the Committee in the end of June 2002.

### C. UTI'S DEPARTMENTAL ENQUIRY ON THE TRANSACTION

18.12 UTI's departmental enquiry was conducted by analysing various documents and the oral evidence of the concerned officials to check the precise sequence of events, whether the investment was made in accordance with normal documented procedure, the robustness and integrity of the decision making process, the objective of the investment and whether it was achieved.

18.13 It was observed in the departmental enquiry on the basis of documentary evidence that:

- (i) Calcutta Stock Exchange (CSE) offered shares to UTI through fax messages. UTI decided to buy 13.30 lakhs shares of M/s DSQ Software from CSE as an off market deal at a negotiated price of Rs. 189/- per share. No documentary proof was available to verify how the price was calculated.
- (ii) Shri B.G. Daga, then an Executive Director of UTI as well as a SEBI nominated Public Representative on the Board of CSE, was asked to provide information on this deal by another ED camped in Delhi on 24.7.2001 as the issue had been raised in the Rajya Sabha. Shri Daga faxed a note which stated that although it had not been mentioned in the letter from the President, CSE it was to be noted that the offer was made to complete the payout of settlement no.148 of CSE, as certain brokers who were to receive these shares in payout had failed to pay. Shri Daga's note of 24.7.2001 went on to state that in the past, there would be some occasions when the UTI had bought shares directly from the Stock Exchanges to enable them to complete their settlements. The departmental enquiry pointed out that the reference to settlement No. 148 had not been indicated anywhere in the records of UTI. In his role as a nominee on the Board of Directors of CSE, Shri Daga had some files relating to CSE, which were handed over to UTI and from where it was seen that the Executive Director of CSE had stated in his report placed before CSE board on 28.04.2001 that, "On 9.03.2001 as no funds were forthcoming from the defaulting brokers and the shortfall of funds primarily related to funds requirements for taking delivery of shares, the President, Vice-President, Executive Director and other Elected Members of the Committee, after discussion, felt that only solution for resolving the payment problem would be to find alternative buyers for the shares in question i.e. 28.42 lakhs shares of Himachal Futuristic Communications Limited (HFCL) and 13.30 lakhs shares of DSQ Software India Limited. Consequently, President was requested to use his good offices to contact UTI and other institutions to explore the possibility of selling these shares to UTI and other institutions. Throughout the day, communications were made to UTI and other institutions for sale of the aforementioned lot of DSQ and HFCL shares."
- (iii) In the minutes of the CSE meeting dated 12.3.2001 it was stated that "Further shares of DSQ Software Ltd. relating to Shri Harish Chandra Biyani and Biyani Securities were placed with Unit Trust of India amounting to Rs. 25 crores approximately." Shri Daga had attended this meeting on 12.03.2001.

- (iv) From the sequence of telephone calls made from Shri Kapur's and Shri Daga's telephone lines it was evident that Shri Kamal Parekh, Shri Daga and Shri Kapur were in contact between 1.15 p.m. till late evening on 9.3.2002.
- (v) UTI library has a 'News snapshot—Daily Trend Comments' service, which is put up to Chairman, EDs and senior officials. This report prepared by the library on 9.03.2001 clearly mentioned the pay out crisis being faced by CSE. The report had been seen and initialed by the ex-Chairman Shri P S Subramanyam. Hence any claim of ignorance of the pay out crisis at CSE by Fund Managers & Senior Officials of UTI cannot be accepted at face value.
- (vi) There is a system of voice recording in the dealing room. Conversations between dealers and the brokers get recorded through a recording machine. Shri Srinivasan (the then Deputy General Manager, Market Operations) testified that he contacted Shri Kamal Parekh from the dealing room on instructions from Shri Kapur. It was observed from the records that cassettes for the period Jan. 2001 to May 2001 were damaged and play back of these cassettes is not possible. The details of what transpired between Shri Srinivasan and Shri Kamal Parekh were therefore not ascertainable. Both Shri Srinivasan, and Shri A N Sridhar, Assistant General Manager in their statements said that it was sometime during June 2001 that it was realized that cassettes were damaged. Shri A N Sridhar also mentioned that the cassettes were in the custody of Department of Dealing and all dealers had access to them and knew the password of the voice recorder. The maintenance company stated that they could not explain the reason for the failure on a visual examination of the tapes but tapes exposed to direct sunlight, magnetic surroundings and age may lose data. It was noted that access controls as a control measure were poor as all dealers had access to the tapes and it was strange that the tapes relevant for the period of this transaction had got damaged without any established cause.

18.14 On the basis of oral evidence the departmental enquiry made the following significant findings:

- (i) Shri Srinivasan , DGM (Market Operations) stated that the then ED (Shri Kapur) informed him about the fax messages which were being sent by CSE and asked that they be given to him on receipt. A total of four fax messages were transmitted by the CSE on 9.3.2001. On receipt of the fourth message Shri Kapur informed Shri Srinivasan that he had spoken to Chairman and decision was taken to accept one offer of CSE. Accordingly, he instructed Shri Srinivasan to close the purchase deal for 13.30 lakhs shares of DSQ Software at Rs. 189/- per share for US-64 directly from CSE. Shri Srinivasan was also asked to contact Shri Kamal Parekh, (President,CSE) to close the deal . As confirmed by Shri Srinivasan he contacted Shri Kamal Parekh over phone and concluded the purchase transaction. He was also asked to include the deal in the statement of the day's transaction in order to take formal approval of Chairman. A list containing all the transaction for the day was furnished to Department of Fund Management (US 64) which was in turn processed and returned to dealing room as per usual practice. Since the transaction in question was a direct deal with CSE it was not entered in the deal sheets and a confirmation note was given to back office for further action. Shri Srinivasan's conversation with Shri Kamal Parekh from the dealing room could not be replayed from the voice recording being done regularly in the dealing room as the cassettes for the relevant period were damaged.
- (ii) Shri B.G. Daga was nominated as Public Representative on the Board of CSE by SEBI. On being asked about the transaction of 9.3.2001 Shri Daga replied that he was not aware of the transaction till 12.3.2001 when he attended the CSE meeting. From the

telephone bills of Shri Daga's office it was observed that he was in contact with Shri Kamal Parekh (President, CSE) on 9.3.2001. When asked about the reasons for being in contact with Shri Kamal Parekh, Shri Daga replied that Shri Parekh was enquiring about Shri Kapur, as he was unable to get his line. Shri Daga also informed that he contacted Shri Kapur's secretary and informed Shri Kamal Parekh that he was available in the office. It can be seen from the sequence of the phone calls between Shri Kamal Parekh-Shri Daga-Shri Kapur that Shri Daga and Shri Parekh were in contact even at 8:41 p.m. in the night for which Shri Daga gave no reply. Details of Shri Kamal Parekh's incoming calls to Shri Daga on Shri Daga's land line were not available since such numbers are not recorded in the bill and the UTI did not have access to Shri Parekh's telephone bills. Shri Daga also said that from the analysis of events post March 2001 it was clear that deal was between CSE and UTI to complete the settlement. As regards the note dated 24.7.2001, Shri Daga confirmed having dictated the note based on the file and information available. He further stated that at the time he recorded the message, the transaction was widely discussed in the media as well as CSE Committee meetings and therefore he tried to give the background of the transaction. The departmental enquiry noted that none of the UTI's internal records indicated the settlement number or the payment crisis till that date and the report of the ED of CSE stated that members of the CSE decided to approach UTI to make a request for purchasing the shares in question. Shri Daga as a Public Representative on the Board of CSE would have been the first contact point at UTI for CSE. The minutes of the CSE committee held on 12.3.2001 confirm that shares were placed with UTI. Even Shri P.S. Subramanyam in his statement stated that Shri Daga had obtained his approval for tour to CSE and he might have been in touch with SEBI, CSE and Shri Kapur. Shri Daga had mentioned in his note that there would be some occasions in the past also when UTI had bought shares directly from the stock exchanges to enable them to complete their settlements. When asked to clarify this, Shri Daga replied that this was based on general media statements that in some previous crisis UTI would have made purchases in similar circumstances and that he had no knowledge about any specific deal. The enquiry noted that it was not acceptable for a written statement by an Executive Director to a colleague for supplying further information to the Rajya Sabha to be based on hearsay or newspaper reports.

- (iii) As per the delegation of powers only Chairman was authorized to approve the purchase of shares from the market. Shri Subramanyam stated that Shri Kapur as an ED of market operations made the deal and informed him. According to Shri Srinivasan (DGM), Shri Kapur gave instructions to him after consulting the Chairman. Shri Subramanyam stated that no processing note was put up for the transaction. On being asked whether he had received any direction from Government of India, CSE or SEBI, Shri Subramanyam stated that he had not received any such direction personally. He was however of the belief that since Shri Daga had obtained his approval for a tour to CSE, he might have been in touch with SEBI, CSE and Shri Kapur. It was however evident from the initials of Shri Subramanyam appearing on the 'News Snapshot' for 09.03.2001 which is circulated to the top management, that the news of the CSE payment crisis was brought to his notice. Based on these inputs the departmental enquiry concluded that the statement of Shri Subramanyam appeared to be defensive.

18.15 The departmental enquiry arrived at the following conclusions:

- (i) The decision making process and the basis on which the discount to the market price was arrived at had not been documented .

- (ii) The letters from CSE indicate that they 'offered' the shares for sale. In a declining market for particular shares, such an offer needed to be examined cautiously by a prudent fund manager. The 'Daily Trend-Comments' sheet circulated by the UTI library information service on 09.03.2001 mentioned CSE's payment problem for settlement no. 148. This information sheet was circulated to all senior officials and was seen by the then Chairman. There was no reason to conclude that UTI's fund managers or other senior officials of UTI who were experienced with dealing on the stock market were unaware of the crisis at the CSE. From the report of the ED of CSE it was clear that CSE faced a payment crisis for settlement No. 148 and President of CSE was in touch with UTI officials. Shri Daga's contention that he was not aware of the deal and that based on media reports he had indicated that in the past also UTI would have made such investments was therefore not convincing.
- (iii) The discussion that took place between Shri Srinivasan and Shri Kamal Parekh could not be replayed from the voice recording, since the tapes recording the conversations in the dealing room for the relevant period were damaged. It is a strange coincidence that the voice recording, which would have been a vital evidence of what actually transpired during the deal, had got corrupted.
- (iv) The report of ED of CSE and sequence of phone calls between Shri B.G Daga, Shri Kamal Parekh and Shri M.M. Kapur showed that they were in contact during the day. Former Chairman Shri P.S. Subramanyam, in his statement had stated—"Shri Daga had taken my approval for tour to CSE. I believe he might be in touch with SEBI, CSE and Shri Kapur". Shri Daga had denied any such contact. Considering Shri Daga's position in the CSE, his relationship with Shri Kamal Parekh, the sequence of telephone calls and the resultant action triggered in UTI plus Shri Daga's attendance in the CSE meeting on 12.03.2001 (the day of payment) there was an overpowering sense that his denial could not be accepted at face value. The enquiry report stated that a detailed examination of officials of the CSE and SEBI would be required in this respect, which would have been beyond the scope of their inquiry.
- (v) Considering the fact that Stock Market price for DSQ shares showed a declining trend during March-April 2001 as well as the 'sell' recommendation of ERC, there was no reason for UTI to buy these shares keeping in view the interest of its unit holders. It could be further inferred that the primary objective of the purchase of shares of DSQ Software was to help CSE during pay-out crisis which action was surely not in conformity with the UTI's mandate. Shri Daga's note also gave a clear indication of the true motivation for the deal.
- (vi) This was not a secondary market transaction transacted through brokers on the floor of an exchange but a direct negotiated deal between UTI and CSE. Prudence required that the investment decision should have been taken after due and formal process of fundamental and technical analysis.
- (vii) So far as the involvement of the UTI's Officials was concerned it was concluded that the late Shri M.M. Kapur, ED, instructed the purchase of these shares after consulting the then Chairman. The days' transaction list had the approval of the Chairman. Therefore Shri M.M. Kapur and Shri P.S. Subramanyam, Ex-Chairman were directly concerned with the decision making process. Also, Shri B.G. Daga, ED, was on the Board of CSE as a Public Representative and was in contact with Shri Kamal Parekh on 9.3.2001. He was the first contact point for CSE to approach UTI for offer of shares though on paper the offer was sent to Shri Kapur. Shri B.G. Daga's statement that his role in decision making was 'nothing what-so-ever' was not convincing and needed to be verified from officials at the CSE.

- (viii) As regards previous instances of such transactions the enquiry was not able to identify such instances, as Shri Daga had not volunteered further information on the basis of his note dated 24.7.2001.
- (ix) Therefore, the entire exercise of purchasing 13.30 lakh shares of DSQ Software from CSE was in the background of meeting of minds of senior level officials of UTI viz. Shri P.S. Subramanyam, former Chairman, Late Shri M.M. Kapur, ED and Shri B.G. Daga, Ex-ED, on receipt of a request from CSE President Shri Kamal Parekh. Available records established that the transaction was not a secondary market operation but a negotiated direct deal with the CSE. The investment decision was taken without any prior documentation of the decision making process. In fact the buy-list, dealers confirmation and ED (Shri Kapur)'s approval were all taken after the deal was put through on the basis of oral clearances and understanding. The transactions were put through to enable CSE to complete settlement no.148. Hence the purpose of the transaction could not be regarded as being in the interest of the unit holders of UTI. Based on the BSE quote for DSQ Software equity on 28.2.2002 at Rs. 45.15 per share, the value of this investment (Rs. 25.13 crore) had depreciated by Rs.19.13 crore and stood at Rs 6.00 crore.

#### **D. ACTION TAKEN BY UTI AND MINISTRY OF FINANCE**

18.16 The memorandum of the Board of Trustees dated 12.4.2002, which considered the departmental enquiry, started off by summarizing the key findings, which were:

- (i) The purchases were made without any background processing note and contrary to the Equity Research Cell recommendation for reducing exposure to the Company. The entire exercise of purchasing shares was undertaken to enable the Calcutta Stock Exchange to complete the settlement no.148.
- (ii) The transaction which was undertaken for the purpose of enabling the CSE to complete its settlement and not for the explicit purpose of maximizing unit holder value could not be regarded as being in the interest of the unit holders of UTI or conforming to UTI's mandate.
- (iii) Based on documentary and oral evidences its stands to reason and logic that the senior officials of UTI, viz., Shri P.S. Subramanyam, former Chairman, Shri B.G.Daga, former Executive Director and late Shri M.M. Kapur had a clear knowledge and understanding of the true purpose of the investment.
- (iv) The purchase was made in a scenario of declining market prices and in the absence of any internal document/report expressing a positive view/expectation of the company. The value of this investment had depreciated by Rs.19.13 crores as on 28.2.2002.
- (v) A major limitation of the enquiry was lack of authority to examine officials and records of SEBI and CSE relating to the CSE pay-out crisis as they were beyond scope and mandate of the inquiry. Secondly, vital evidence in the form of dealing room voice recordings pertaining to the relevant period had coincidentally got corrupted and was not available for examination.

The Board of Trustees outlined future steps like decentralization of powers, creation of a new mid office between the dealing and fund management function and appointment of a senior vigilance officer from outside to avoid recurrence of such an event. Regarding further action based on the departmental enquiry, the Board of Trustees decided to forward a copy of the

report along with its observations to the Government of India for their information and necessary action.

18.17 The Ministry of Finance subsequently informed the Committee that the Government had advised UTI to take stern action under the appropriate law and rules of UTI against those found involved in irregular practices. UTI was further advised by the Ministry to inform the principal shareholders of Central Depository Securities Limited (CDSL) for appropriate action at their end about the irregularities and the findings that had come to light involving Sh. B.G.Daga, the then ED, and currently the Managing Director of CDSL. As advised by the Ministry, UTI took the following actions:

- (i) A formal complaint was lodged with the Central Bureau of Investigation, Economics Offences Wing at Mumbai on 18.7.2002 naming three former senior officials of the UTI Shri P.S. Subramanyam, Late Shri M.M. Kapur and Shri B.G. Daga for their involvement in the transactions.
- (ii) UTI wrote to the principal shareholders (Bombay Stock Exchange, HDFC Bank, State Bank of India, Bank of Baroda and Bank of India) of Central Depository Securities Limited (CDSL) informing them of the irregularities and findings brought out in the Enquiry Report involving Shri B.G. Daga, the then Executive Director for appropriate action. It was also decided by UTI not to release any monetary or non-monetary post-retirement benefits to Shri B.G. Daga.
- (iii) Since Shri P.S. Subramanyam, former Chairman of UTI was no longer in the service of the Trust and as it was understood he might be drawing post-retirement benefits from his former employer, the IDBI, a letter was written to the Chairman, IDBI explaining the circumstances and requesting appropriate action as deemed fit.
- (iv) In response to UTI's letter, the Bombay Stock Exchange, which is one of the principal shareholders of CDSL, requested UTI to forward it a copy of the inquiry report for study by their governing board. Since according to UTI, this was an internal and classified document, they conveyed their inability to share it with BSE and suggested that BSE directly contact the Government of India for any further clarification. Subsequently, the BSE informed UTI that the matter had been placed before the Governing Board of the exchange, which had decided to obtain a legal opinion after which they would take a further decision on the matter.

**18.18 Having gone through the various enquiry reports and depositions, the Committee are of the view that:**

- (i) The unit holders of UTI have been subjected to a loss of Rs. 21.40 crore as on 28.6.2002 on an investment of Rs. 25.13 crore made by UTI based on a decision which violated norms of prudent decision making.**
- (ii) Shri P.S. Subramanyam, the then Chairman and late Shri M.M. Kapur, Executive Director approved the transaction which any prudent person could have foreseen would lead to a loss to UTI.**

The Committee recommend that UTI and the Ministry of Finance follow up and expedite all the proceedings mentioned in para 18.17, which were initiated as a result of their enquiry into UTI's off market transaction with CSE. In this connection, the Committee suggest that the investigative agencies examine the telephone records of Shri P.S. Subramanyam and others concerned to ascertain who was in touch with whom on 9.3.2001.

18.19 The Committee have had occasion to examine the CSE, Stock Holding Corporation of India (SHCIL), SEBI, UTI and their officials in different sittings while looking at the crisis on CSE. The share transaction funding schemes of SHCIL were extensively used by one of the defaulting CSE brokers, Shri Harish Chandra Biyani to fund transactions in the shares of DSQ group. As there was prima facie evidence before the Committee that SHCIL had violated prudential norms and internal procedures to facilitate these transactions, SEBI was asked by the Committee in June 2002 to prepare an inspection report focusing on SHCIL's funding transactions as its earlier report of May 2001 was silent on these aspects. The findings of SEBI's report have been discussed in detail in Chapter IV of Part I of the report. The Committee have in sifting through the reports, depositions and evidence placed before them, observed a disturbing nexus which stands established by the following facts:

1. Shri P.S. Subramanyam was Chairman of UTI as well as SHCIL at the time of the transaction. UTI is one of the promoters of SHCIL.
2. Shri B.G. Daga was the Executive Director of UTI as well as UTI's representative on the Board of Directors of SHCIL.
3. Shri H.C. Biyani and his related entities were the brokers involved in both transactions.
4. As per the report of SHCIL's Vigilance Advisor and later confirmed in SEBI's inspection report, Shri H.C. Biyani is the broker of Shri Dinesh Dalmia who is the main promoter of the DSQ group.
5. As per the report of SHCIL's Vigilance Advisor, oral evidence tendered to the Committee and later confirmed by SEBI in its inspection report, Shri Dinesh Dalmia lobbied with SHCIL to fund the transaction involving the scrip of DSQ Industries.
6. The transactions of both SHCIL and UTI involved the shares of DSQ group.
7. These transactions took place on CSE in the first and second week of March 2001.
8. UTI had the choice of buying either the scrip of DSQ Software or HFCL but went ahead and bought the former even though there was a specific recommendation by its Equity Research Cell that it should sell its existing holdings of the share.
9. Shri H.C. Biyani and related entities entered into circular transactions on CSE in the scrip of DSQ Industries. They obtained funding from SHCIL through its sell and cash scheme by misrepresenting these transactions as being at arms length. The transactions were later annulled by CSE as on enquiry they found that they were between entities belonging to the same group of persons and appeared to be accommodation transactions.
10. Another large transaction in the scrip of DSQ Industries undertaken by H.C. Biyani and his related company was funded by SHCIL through its cash on payout scheme. SHCIL violated its procedures to facilitate this transaction as well as Shri H.C. Biyani's subsequent discounting of SHCIL's postdated cheque by issuing letters of comfort to IndusInd Bank, which had never been done in any other transaction.
11. According to the SEBI inspection report, companies linked to the promoter of DSQ group provided the shares of DSQ group to Sh. Biyani through off market deals, which he then traded on the CSE.

12. Both UTI and SHCIL's decisions were found to be imprudent, in violation of laid down procedures and have extracted a heavy price in terms of financial loss and loss of reputation and customer confidence.
13. The damage to the vital dealing room tapes recording UTI's transaction with CSE is suspicious.

18.20 The Committee see that all these events point to a close nexus between the corporate promoter, defaulting brokers acting on behalf of the promoter, broker directors on CSE and public officials in SHCIL and UTI. The Committee recommend that the following consequential steps may be taken:

- (i) CBI should expedite its enquiries and subsequent action on the complaint filed by UTI in the matter.
- (ii) The Committee have been informed by the IDBI, one of the promoters of SHCIL, that its nominee is currently the Chairman of SHCIL and that it has decided to carry out a special investigation of SHCIL's role, fix accountability and punish the guilty. The Report has now been received and the Committee desire that it should be followed up expeditiously.
- (iii) SEBI's inspection report on SHCIL has pointed out a number of irregularities. The Committee desire that investigation be concluded without delay and suitable action taken against the concerned persons.
- (iv) The Committee desire that RBI should institute an enquiry regarding the discounting of post dated cheques issued by SHCIL to Biyani group by IndusInd Bank. It should direct IndusInd Bank to take appropriate administrative measures if it finds any procedural or regulatory violations. RBI's enquiry should also look at the role of Indus Ind Bank in financing all the brokers responsible for the payment crisis on CSE. RBI should also institute changes in the procedure for discounting post-dated cheques if it detects any legal or procedural ambiguities. Indeed this action should have commenced.
- (v) Chairman, SEBI should institute an independent enquiry regarding whether there was any improper conduct by any SEBI official deputed by it to handle the payment crisis at CSE, specifically the antecedents of the deputed official, whether he was sent in the normal course of the responsibilities assigned to him, and if he had any role in facilitating UTI's off market purchase from CSE. Chairman, SEBI should take appropriate administrative action on the basis of the report.
- (vi) SEBI, Enforcement Directorate and DCA have already instituted enquiries in case of the DSQ group, which are at different stages. These should be expedited.

The Committee hope that swift action as detailed above will send the right signals to the stock markets and other financial institutions.

## CHAPTER XIX

### ROLE OF TRUSTEES

19.1 In terms of the Unit Trust of India Act, 1963, the general superintendence, direction and management of the affairs and business of the Trust are vested in the Board of Trustees (BoT). In terms of Section 10 of the Act the Board of Trustees consists of eleven members, which include the Chairman who is appointed by the Central Government in consultation with the Industrial Development Bank of India (IDBI), four nominated by the IDBI, one each nominated by the Life Insurance Corporation (LIC), Reserve Bank of India (RBI) and the State Bank of India (SBI), two elected by the institutions who contributed to the initial capital, and an executive trustee, again appointed by the IDBI (though if the Chairman is whole-time, it is not necessary to appoint an executive trustee). The UTI Act provides that the Board of Trustees may exercise all powers and do all acts and things, which may be exercised or done by the Trust. In terms of Section 9(2) of the Act, the Board of Trustees shall in discharging its functions, act on business principles, having regard to the interest of the unit holders. The Board of Trustees, being a collective body constituted as per the provisions of the UTI Act, is governed by the usual principle of collective responsibility. According to the UTI the Board meets at least once in two months but according to the MoF the BoT reviews the performance of the Trust every quarter. The UTI Act also provides for an Executive Committee (EC) comprising the Chairman, an Executive Trustee and two other trustees nominated by IDBI. The Executive Committee enjoys such powers as are delegated to it by the Board. The UTI has informed that the EC normally meets once a month.

19.2 As detailed in Chapter XVII of this Report, for four successive years from 1994-95 to 1997-98, the UTI declared dividends in its US-64 scheme in excess of its net income, so that in 1997-98, the reserves of the scheme were actually wiped out and turned negative. The Tarapore Committee has noted that, "The distribution of high dividend during 1994-95 by dipping into reserves, in the absence of a NAV, implied that there were inter-temporal gains and losses to unit holders and one set of unit holders had to bear a burden on account of another set of unit holders". It has also observed that, "Raising the dividend yield in 1996-97 and 1997-98 as compared with 1995-96 was, in retrospect, not a prudent step and not justified by the results of the scheme". It has also stated, "It is pertinent to note that, during 1997-98, a significant change in the accounting policy was effected. During the year, the investment portfolio depreciated sharply by Rs. 3,566.04 crore, which was charged to the 'reserves and surplus' account, unlike in earlier years when depreciation, if any, was charged to the 'Revenue Account'. As a sequel to this significant change in accounting policy, 'reserves and surplus' as at the end of June 1998, turned negative at Rs. 1098.49 crore. Had this accounting practice not been followed, net income would have been zero." The Tarapore Committee has also commented that in a non-NAV based scheme like US-64 a certain level of prudential reserves should have been maintained to meet redemption pressures which was not done in all these years.

19.3 The Committee have perused the minutes of the meetings of the Board of Trustees of UTI as well as the memoranda submitted by the UTI management to the Board regarding estimates of income and fixation of income distribution for the US-64 scheme for the years 1994-95, 1995-96,

1996-97 and 1997-98 when dividends were declared in excess of the annual income of the scheme. Extracts from the memoranda and the Board minutes relating to estimates of income and fixation of income distribution for US-64 scheme in these years are at **Appendix-XXXVI** and details of the trustees who attended these meetings are at **Appendix-XXXVII**. The Committee note the following:

- (i) For the year 1994-95, the memorandum to the Board gives the current income as well as the surplus of previous years and states that the surplus of the previous years carried forward can be considered available for income distribution along with current income. The memorandum details the income distribution alternatives for dividend rates of 20%, 22%, 25% and 26% and mentions that the previous year's rate was 26%. The minutes of the meeting of the Board state that after detailed discussions the dividend rate was decided at 26%.
- (ii) For the year 1995-96, the memorandum to the Board states that the current years surplus as also the surplus of the previous year can be considered for income distribution. It details the income distribution alternatives for dividend rates of 14%, 14.5% and 15% and indicates that for the last two alternatives the distribution will be marginally in excess of net income which will have to be drawn from the General Reserves. It therefore recommends a dividend no higher than 15% and a bonus of 1:8 so that investors would get a benefit of 15% dividend (in cash) and 12.5% in bonus units. The memorandum specifically concludes that any dividend or bonus ratio higher than this would impose liquidity and income constraints on the scheme and lead to a fall in the NAV, which would be detrimental to its future. The minutes of the Board meeting merely state that after detailed discussions the dividend rate was decided at 20% and bonus units ratio at 1: 10.
- (iii) For the year 1996-97, the memorandum to the Board details the income distribution alternatives for dividend rates of 18%, 19% and 20% and specifically mentions that in order to maintain the previous years dividend rate of 20%, it may be necessary to use the General Reserve of the scheme. It however recommends that given the income distribution rates of previous years and the fall in the rate in the previous year from 26% to 20%, a dividend distribution rate of 20% be maintained. The minutes state that after detailed discussions the dividend rate was decided at 20%.
- (iv) For the year 1997-98, the memorandum to the Board mentions the net current income of the scheme excluding provision towards depreciation in the value of investments—a significant departure from previous years when the depreciation in the portfolio was included in the net current income. Despite the fact that accounting for this depreciation in the portfolio would wipe out the entire current income of the scheme, the memorandum states that the current income of the scheme is sufficient to make a dividend distribution of 20% without considering the provision for depreciation of the portfolio. It proposes an ad hoc provision of Rs. 100 crore for depreciation in the portfolio and mentions that the final provision will be made on the basis of the market price as on 30.6.1998. The memorandum then details the income distribution alternatives for dividend rates of 18%, 19% and 20% (without making any provision for depreciation of the portfolio and including the general reserves in the amount available for distribution) and proposes a dividend rate of 20%. This is the only year in which the minutes of the Board meeting mention a discussion about the dividend rate proposed in the memorandum. One trustee suggested that in view of the steep fall in the indices, a conscious decision be made to buy good quality equity when prices were low while another pointed out that the US-64 scheme had too large an exposure to equity. The Chairman's view was that the decline in the Sensex was sudden and

temporary, so only an ad hoc provision of upto Rs. 100 crore for depreciation in the US-64 portfolio was proposed instead of making a full provision. Regarding the rate of dividend a trustee suggested that a lower rate should be considered while another stated that a reduction would have an extremely adverse impact on the scheme. The Board took the view that looking to the fundamental strengths of the economy and indications of improvements in corporate sector performance in 1997-98, there were reasons to believe that the depreciation in the equity values was temporary. Since the US 64 was an open ended scheme which had offered consistent return to investors over decades and any reduction in dividend owing to the temporary depreciation of the equity portfolio might cause large scale repurchases forcing the Trust to sell the assets of the scheme causing a further fall in the indices and destabilising the market, the Board took a long-term view and decided to make only ad hoc provisions for depreciation of the US-64 portfolio and approved the proposed dividend of 20%.

19.4 When Sh. S.S. Tarapore (who served as a RBI nominated trustee on the Board of UTI from 14.9.90 to 27.3.95), was asked about the extent to which the Board of Trustees was responsible for the state of affairs in UTI given that powers were centralized in the hands of the Chairman without any delegation, his reply was,

“...I would only submit that having been a trustee, one cannot absolve oneself from constructive responsibility for the period one has been a trustee. I mean, one may have been ineffective, but if you are a trustee, naturally, you are vulnerable as a trustee to that extent. What I would submit is that at least during the period I was there, 1990-1995, the milieu in which we worked in was such that, corporate governance of Board run activity was very minimal. When you look at minutes, you will find that the minutes were written in the so called ‘winner takes all’ style i.e. the ‘Item was approved’. There would be an economy of words. If there was an objection or something like that, that did not get recorded, while in the later years—we recorded this in our Report—where there is a difference of view, that has been recorded, as corporate governance had increased, as non-executive Board became more active. As you go into the earlier years, the executives virtually have all along ruled over the non-executives”.

19.5 The Committee agree that the Board of Trustees must accept constructive responsibility for going along with the UTI management’s suggestions for unrealistic dividend rates in these years. The Committee however also recognize the milieu of corporate governance in UTI, the concentration of powers in the hands of the UTI executive, the fact that it was the UTI management which proposed these dividend rates and the compulsions not to lower dividends to avoid large redemptions in the US-64 scheme in this period. Keeping these in view, the Committee are particularly exercised over the role of the Board of Trustees which decided the dividend for the year 1995-96, because the UTI management had specifically proposed a dividend of 15% and a bonus of 1:8 for the US-64 scheme in this year (which according to their calculations gave the unit holders an overall benefit of over 26% for the year and a yield of around 20%) and had also pointed out that anything higher than this would be detrimental to the liquidity and the NAV of the scheme. As the minutes are totally silent about why the suggestion of the UTI management was not accepted and why a much higher dividend of 20% and a bonus of 1:10 was approved, the Committee can only conclude that this may have been done so that the dividend was not too unfavourable when compared to the previous years’ dividend of 26%. This still does not explain what prompted the Board of Trustees to overturn the recommended dividend and declare a much higher one when the management of UTI had already taken all factors into account and when in all other years the Board of Trustees had accepted the recommendations made to them. This activism on the part of the trustees was disastrous for the scheme as the dividends

were distributed from the reserves. The roots of the problems of US-64 lie in these imprudent decisions of the Board of Trustees for which they must bear responsibility.

#### A. ROLE OF IDBI

19.6 The composition of the BoT and the EC clearly indicates that the UTI is controlled by the IDBI. The primary role in UTI's affairs was earlier that of RBI, but with the passing of the Public Financial Institutions Laws (Amendment) Act, 1975, these powers were vested with the IDBI. Out of eleven members on the BoT, the Chairman is appointed by the Central Government in consultation with IDBI, four trustees are its nominees and the Executive Trustee is also appointed by IDBI. The EC is totally controlled by IDBI, as it comprises of the Chairman, Executive Trustee and two IDBI nominees. In the last ten years, the UTI has had four Chairmen, Shri S.A. Dave (30.3.90 to 30.1.96), Shri Jagdish Capoor (2.2.96 to 31.12.96), Shri G.P. Gupta (1.1.97 to 30.6.98) and Shri P.S. Subramanyam (8.9.98 to 3.7.2001). All of them with the exception of Shri Capoor who was in the chair for only eleven months have worked in IDBI. Infact, Shri Gupta and Shri Subramanyam were Executive Directors in IDBI immediately prior to their respective appointments as Chairman and Shri Gupta went on to head IDBI immediately after leaving UTI. Also, the Chairman and Managing Director of IDBI was always one of the IDBI's nominees on the BoT as well as the EC and was therefore privy to all the investment decisions of the UTI. The Chairman and Managing Directors of IDBI who were on the BoT of UTI in the last ten years were, Shri S. H. Khan (as ED IDBI from 9.1.89 to 4.2.92, as MD, IDBI from 5.2.92 to 1.12.93 and as CMD, IDBI from 2.12.93 to 30.6.98), Shri G.P. Gupta (6.11.98 to 31.1.2001) and Shri S.K. Chakrabarti (for four months from 1.3.2001 to 31.7.2001)

19.7 The UTI Act gives specific powers to IDBI. Unders 29 of the Act, the IDBI may, from time to time, call upon the UTI to furnish such information as it may require. Similarly under s.30, the Trust is bound by the written directions, which the IDBI may give it in matters of policy involving public interest. Section 26 provides that UTI's auditors will be appointed with the previous approval of the IDBI. It is clear to the Committee that statutorily it is IDBI that is accountable for the omissions and commissions of UTI as an institution.

19.8 In the JPC report enquiring into the irregularities in securities and banking transactions of 1992, it was noted that, "Despite market operations of Rs 35,000 crores, no inspection of any kind, has ever been done about the activities and operations of the UTI." The MoF had responded by stating that, "Under the Act, RBI and IDBI are authorised to call upon UTI to furnish such information as they may require. Both RBI and IDBI have been calling upon UTI to furnish information periodically." However, the IDBI never invoked these sections prior to 2001.

19.9 The Executive Committee of the UTI consisted of the Chairman (appointed by the Central government in consultation with IDBI), Executive Trustee appointed by the IDBI and two nominees nominated by the IDBI. The accountability of the Executive Committee of the Board of UTI (which was totally dominated by IDBI nominees) in allowing assured return schemes has already been pointed out in Chapter XVI.

19.10 As pointed out in Chapter XVI, UTI has participated in consortium lending and has also sanctioned additional funds to the same companies as part of a consortium of financial institutions where the additional funds have been adjusted against outstanding payments. Some of these non-performing loans were also transferred from other schemes to UTI's assured return schemes, contributing to their low returns and liquidity problems. The UTI Act was amended with effect from 1986 to permit these lending activities, which often resulted in attenuation of credit discipline. UTI's participation in the consortium of financial institutions which cleared these loans was either headed by IDBI as a lead institution or had IDBI as a member and the project appraisal was done by IDBI, ICICI or IFCI since UTI as an investment institution did not have the skills to

evaluate infrastructure projects. 81 per cent (Rs. 927.8 crore out of Rs. 1140.3 crore) of UTI's loans advanced as a member of IDBI led consortiums are currently non-performing assets.

**19.11 Though IDBI has stated that UTI's participation in consortium lending was on its own volition and based on its commercial judgment, the Committee have concluded that given the dominance of IDBI nominees and appointees on the decision making bodies of UTI, the powers of issuing directions granted to IDBI by the UTI Act and government policy promoting directed institutional financing to infrastructure projects, UTI's participation in consortium lending was a foregone conclusion. As much as the declaration of high dividends, it was the imprudent financing of long gestation projects, which lay at the root of the problems that overtook UTI. Also, although IDBI started its own mutual fund in 1994, it continued to dominate the affairs of UTI, despite the obvious conflict of interest. IDBI should have taken the initiative to withdraw itself from control of UTI and its presence on the Board of Trustees of UTI at this stage.**

## **B. ROLE OF MINISTRY OF FINANCE**

19.12 While the specific role of the Ministry of Finance relating to the suspension of sale and purchase of units in the US-64 scheme has been discussed in Chapter XVIII, its role as a nominated trustee on the BoT of UTI are discussed in this section. The government has been represented on the Board of Trustees of UTI since the inception of the UTI in 1963. This has been accomplished through the offices of the IDBI, which nominates the Joint Secretary in the Ministry of Finance or another official of the Ministry as one of its nominees on the Board of UTI. The government nominees since the last JPC Report have been, Dr. P.J. Nayak (30.6.93 to 30.9.94) who was subsequently appointed Executive Trustee by the IDBI from 22.5.96 to 31.12.99 and then became CMD of UTI Bank; Dr. Arvind Virmani (27.9.94 to 1.5.97), Dr. J. Bhagwati (21.7.01 to 14.6.2002 and Shri U.K. Sinha (21.6.02 till date). The only period when the Ministry of Finance was not directly represented on the Board of UTI was from 2.5.97 to 20.7.01, a period of about four years. When asked the reasons for withdrawing the IDBI-government nominee from the Board in 1997, the Secretary Finance in his oral evidence has stated that,

"...the overall position since 1991 in a regime which is liberalised has been that these bodies in the financial markets should move towards as much autonomy as possible. The Government or the Ministry should not interfere in its day-to-day working. The people who are appointed there are responsible and they should be allowed to function."

When asked why, in that case, the government nominee had been reappointed now in 2001, his reply was,

"...I would put it this way that the government had been adopting this hands off policy since 1991. Now, after the debates in Parliament on these issues, we do realize that the presence of the representatives of the Ministry of Finance on UTI Board would be useful to keep the ministry informed constantly as to what is happening."

When the current Chairman, UTI was asked the reason for the withdrawal of the government nominee, he stated that he was unaware of the reasons. The former Chairman, Shri P.S. Subramanyam, however, had a different opinion about the withdrawal. According to him,

"I understand that the Government nominee was withdrawn in the wake of a large investment that had taken place in a mega-group company." He further stated that, "I understand it was Reliance because it happened in the earlier period. This is what I understand."

He has further stated,

“...The Government did not want to have any embarrassment on that issue, and, therefore, I understand the nominee was withdrawn.”

**19.13 Whatever may have been the intention of the government in withdrawing its nominee from the Board of Trustees, the stated purpose of letting the institution function autonomously and having a hands off policy did not, in retrospect, bring about any improvement in the functioning of UTI, as subsequent events like the distribution of dividends from reserves and the disastrous investment decisions show. The Committee note that in two of the years when dividend was distributed in excess of the income for the year, i.e. 1994-95 and 1995-96, there was a government nominee on the Board. It therefore seems to the Committee that the presence or absence of a government nominee on the Board of UTI did not result in improvement or deterioration of the functioning of UTI.**

### **C. ROLE OF OTHER TRUSTEES**

19.14 The other Trustees on the Board of UTI are one nominee of the RBI, LIC and SBI besides two trustees who are elected from among the 35 financial institutions and banks who had contributed to the initial capital of UTI. Both SBI and LIC floated their own mutual funds in 1987 and 1989 respectively but their representation on the BoT of UTI continued by virtue of the UTI Act, despite the conflict of interest. SBI redeemed US-64 units worth Rs. 354.89 crore in April-May 2001, the largest redemption by a single entity, which was one of the contributory factors to the heavy redemption pressure on the US-64 scheme. An SBI nominee being permanently on the Board of Trustees of UTI, this led to doubts that SBI had inside information about US-64, prompting the redemptions. The US-64 scheme had borrowed funds from UTI's other schemes to meet its repurchases and had subsequently borrowed Rs 1000 crore from SBI to tide over its liquidity problems for which discussions were held with SBI in the end of May 2001. While the Tarapore Committee has concluded that insider trading was not involved, the incident highlights the anomaly of an institution like SBI, which is a competitor, client as well as a banker of UTI, being on the Board of Trustees. The former Chairman, UTI, Sh. P.S. Subramanyam has stated,

“I submitted earlier that when the IDBI had got the transfer of the initial capital holding from the RBI to itself, then the IDBI, LIC as well as the SBI started their own mutual funds. In fact one wonders how that happened and how in spite of that, the official nominees of the institutions continued on the Board of Trustees of the UTI. In fact, in a presentation, which I had made to the Finance Secretary... I had pointed out the information which is available to the Board of Trustees of the UTI. I did not say that in clear terms that like it would get passed on to their mutual funds. But there is always a probability.”

19.15 Regarding the role of the RBI nominee, the RBI has stated, “The RBI nominee on the Board of UTI is only one among the ten Trustees of UTI. In so far as the superintendence and management of UTI are concerned, the RBI nominee has only a collective responsibility along with other Trustees of UTI. As a nominee of RBI, his/her role is to ensure that actions/activities of UTI, in no way, impinge on the monetary policy formulated by the Reserve Bank and the proposals brought to the Board do not, in any way, involve violation of directives/guidelines framed by RBI from time-to-time. The important role of the RBI nominee is to ensure that the Trust is guided by such directions in matters of policy involving public interest as the Reserve Bank may give it. Thus, RBI nominee has only collective responsibility along with other Trustees as laid down in the UTI Act, namely, to act on business principles in the interest of the unit holders.” In fact, the RBI nominee along with the IDBI nominees had a greater responsibility than the other trustees as only the RBI and the IDBI could give directions in writing to the UTI in matters of policy, which the UTI was bound to follow. However, leaving aside this power, RBI's primary

role in UTI had been vested with IDBI after the amendments to the UTI Act in 1984. It may also be mentioned that the RBI has since 1995 formally asked the government to disassociate it from the working of UTI. The RBI has informed the Committee that, "An arrangement (similar to one under UTI Act) of nominating an officer of the Bank was in vogue in the case of IDBI also, on the Board of which a Deputy Governor of RBI used to be nominated by us, as required under Section 6 (b) of the Industrial Development Bank of India Act, 1964 as amended in 1975 effective from February 16, 1976. However, pursuant to the amendment to the IDBI Act *vide* IDBI (Amendment) Act, 1995, the requirement of nominating a Deputy Governor of RBI on the Board of IDBI had been dispensed with, with effect from October 12, 1994. Taking a cue from this amendment, RBI had, as far back as in January 1995, suggested to the Government *vide* the then Governor, Dr. C. Rangarajan's D.O. letter dated January 2, 1995 addressed to the then Finance Secretary, Shri Montek Singh Ahluwalia, that the Section 10 (aa) of the UTI Act may be deleted from the Statute." Though the government agreed with this suggestion, it has till date not been implemented.

**19.16 In the light of the conflicts of interest discussed above, the Committee recommend that IDBI should be divested of its representation on the Board of Trustees as well as the powers given to it under the UTI Act. Similarly SBI and other public financial institutions should also withdraw from the Board for the same reason. RBI, whose role is of a regulator, should also not have representation on the Board of Trustees of UTI.**

## CHAPTER XX

### MINISTRY OF FINANCE AND UTI

20.1 The Capital Market Division of the Department of Economic Affairs in the Ministry of Finance, besides dealing with other issues relating to the capital market also deals with organizational matters relating to UTI and SEBI and the administration of UTI Act, 1963 and Securities and Exchange Board of India Act, 1992. The Capital Market Division acts as the Secretariat for the High Level Coordination Committee on Financial and Capital Markets (HICCFM), which was constituted for greater coordination among regulatory agencies in the financial capital market. The division is headed by an officer of the rank of Joint Secretary who reports to the Secretary through an Additional Secretary.

20.2 The role of MoF in the redemption crisis of US-64 and as a Trustee on the Board of Trustees of UTI has been alluded to in Chapters XVII and XX of this report. In line with the terms of reference to go into all matters relating to UTI, the Committee interacted with the four Finance Ministers who have held office since the early nineties, *i.e.* Dr. Manmohan Singh (21.6.1991 to 16.5.1996), Shri P. Chidambaram (1.6.1996 to 21.4.1997 and 1.5.1997 to 19.3.1998), Shri Yashwant Sinha (31.11.1990 to 21.6.1991, 19.3.1998 to 1.7.2002) and Shri Jaswant Singh (16.5.1996 to 1.6.1996 and 1.7.2002 till date).

#### A. FAILED INITIATIVES TO RESTRUCTURE UTI AND AMEND THE UTI ACT

20.3 The need for a change in the UTI's structure, management and regulation to bring its activities in line with other mutual funds and the regulations prescribed by SEBI was identified by the MoF right since 1992.

- (i) Ever since 1992, the Ministry of Finance pursued with UTI the need for UTI to come under the regulatory jurisdiction of SEBI as well as the need for splitting up UTI's mutual fund activities from its lending functions. *Vide* letter dated 2.7.92, the then Finance Secretary (Sh. M.S. Ahluwalia) wrote to then Chairman, UTI (Dr. S.A. Dave) that even if it was consciously decided to exclude UTI from the purview of SEBI because of its unique character in that it was both a mutual fund as well as a term lending institution, there was still a need for UTI to adhere to investor protection guidelines being laid down by SEBI, specially as other mutual funds including those run by nationalized banks and other public institutions were being made to comply with these guidelines. The letter also suggested that if the special character of UTI was the only reason for not subjecting UTI to SEBI guidelines, the problem could perhaps be handled by splitting up the mutual fund function of UTI into a separate asset management company. Again, through a letter dated 18.3.1993 the Finance Secretary forwarded to Chairman, UTI, a comprehensive discussion paper prepared by the Ministry in which alternative ways of regulating UTI had been considered and it had been concluded that the best way of reconciling various conflicting considerations would be to divide UTI into separate legal entities. The letter sought UTI's views on this discussion paper so that the Ministry could take a final view in the matter. The Chairman, UTI responded to this by stating in his letter dated 7.4.1993 that

UTI was studying the discussion paper but cautioned that with a view to rationalize UTI's operations, it was necessary that changes in the current regulatory framework for UTI were brought in a manner that could best exploit UTI's strength and potential for future global operations. The letter further stated that UTI's detailed comments and suggestions on the discussion paper would be sent later. Again on 12.7.93, the Finance Secretary wrote to the Chairman UTI on the need to subject UTI to the same SEBI regulations as were applicable to other mutual funds. It reiterated the Ministry's view that irrespective of the fact the UTI was governed by its own statute, the relationship between the UTI and its unit holders was essentially similar to that between a mutual fund and its investors and therefore it was desirable for the protection of investors that this aspect of UTI's activities be subject to SEBI regulation as for other mutual funds. The letter also recognized that UTI had certain special characteristics, which needed to be kept in kind while determining the appropriate modalities for regulation by SEBI. The letter therefore requested UTI for its reaction on the earlier discussion paper and stated that Ministry would be willing to consider alternative approaches to achieve the basic objective of subjecting UTI to suitable regulation to ensure investor protection. It seems that UTI did not send its comments and suggestions on the discussion paper. Instead, *vide* letter dated 19.7.1993 Chairman, UTI conveyed to the Finance Secretary that UTI was a unique financial intermediary combining elements of a financial institutions, bank and mutual fund with a unique form of organization governed by a self-contained code and regulatory framework provided in the UTI Act itself, that UTI had been an Indian innovation and a highly successful one and therefore any proposal for change in the regulatory and investor protection measures relating to UTI's operations would warrant a careful and in-depth study of various issues which could best be handled by experts and those closely associated with and affected by UTI's operations. The letter stated that UTI had therefore decided to constitute a Committee consisting of three members of the Board of Trustees headed by Shri N. Vaghul, Chairman, ICICI to study the relevant issues in detail. The Finance Secretary responded *vide* letter dated 28.8.1993, that the governments view was that UTI's mutual fund activities should be subjected to appropriate SEBI regulation but the regulation should reflect the special characteristics of UTI. The letter further stated that the Ministry had asked the Vaghul Committee appointed by UTI to go into this issue and had decided to await its recommendations before taking a final view in consultation with SEBI.

(ii) The terms of reference of the Vaghul Committee were:

- (a) To study the adequacy of existing regulatory safeguards under UTI Act to protect interests of investors under different Schemes of UTI.
- (b) To study the strengths of UTI and its existing organization/structure from the points of view of mobilization of resources, investors' confidence, returns to investors, quality and cost of service to investors, efficiency in providing finance to borrowers, and UTI's future growth, diversification and globalisation in the context of liberalization and economic reforms.
- (c) To make appropriate recommendations and suggest alternatives, if any, for ensuring adequate investor protection while best exploiting UTI's strengths and potential for growth, diversification and globalisation of operations in the emerging financial sector environments.
- (d) To consider whether in addition to (c) above, UTI should be subjected to SEBI regulation and if so, what special consideration would need to be built into the regulations to reflect UTI's special status.

The Committee's report was submitted in September 1993 and its recommendations were:

- (a) It would be in the interests of the UTI and UTI's investors if regulatory jurisdiction of SEBI was extended to UTI's mutual fund schemes.
- (b) UTI should form one or more Asset Management Companies as may be necessary as its subsidiaries to undertake the functions of management of mutual funds. These asset management companies would be strictly in accordance with the requirements of SEBI and would be subjected to the regulatory jurisdiction of SEBI. The mutual funds that would be floated by the Asset Management Company would also be required to conform to the mutual fund regulations issued by SEBI. To the extent the Mutual Fund regulations were considered restrictive and stifling innovation, the matter could be taken up with the Government and SEBI for giving UTI any special dispensation, having regard to its experience, size and track record.
- (c) The first category of existing UTI schemes were 15 "mutual fund" schemes of UTI which were generally in line with SEBI guidelines, a large portion of their investments consisted of equities and they had not given any term loans. As soon as possible, the management of these schemes should be vested with the Asset Management Companies after completion of the required formalities, if required.
- (d) The second category of existing UTI schemes were "non mutual fund schemes", (the most notable being US-64) in which close to 60% of the investments were debt instruments and term loans. These activities had been undertaken by UTI in its role as a financial institution. Public interest demanded that UTI continue with this part of its activities so that in future, while the mutual fund activities would be undertaken by the Asset Management Companies, the parent i.e. UTI would concentrate on term loans and debt instruments.
- (e) In its role as a term lending institution, UTI had certain advantages when compared to other such institutions due to its ability to raise resources by sale of units and certain other advantages conferred by the UTI Act. The requirements of fair play and level playing field would dictate that in respect of its term lending activities, UTI should be brought on all fours with other term lending institutions. However, considering the advantage accruing to the economy as a whole by virtue of UTI's vantage position in the mobilization of savings of the community and pending detailed consideration of this issue UTI should continue to enjoy these distinct advantages in its operations as an interim measure.
- (f) If the recommendations of the Committee were accepted, the organizational structure of the UTI in its role as a financial institution would need to be reviewed and the issues that arose in paras (a), (b) and (c) of the terms of reference should be examined along with this review.
- (iii) The Joint Parliamentary Committee to Enquire into Irregularities in Securities and Banking Transactions which presented its report on 21.12.1993, stated :

"The Committee are also in agreement with the views of the Ministry of Finance that the Mutual Fund operations aspect of UTI functioning ought to be brought under the purview of SEBI. If necessary, the UTI Act may be amended accordingly."

The government in its Action Taken Report presented to Parliament stated that,

"The Government has decided that the UTI would come under the regulatory jurisdiction of SEBI. Accordingly, SEBI has been requested to work out an appropriate

regulatory framework for this purpose, taking into account the special characteristics of UTI."

- (iv) Governments assurance to Parliament and the recommendations of the Vaghul Committee culminated in a regulatory framework for UTI, which was worked out by SEBI on the basis of the Ministry's letter dated 16.3.1994 which stated,

"As UTI is not a regular mutual fund and has evolved into a distinctive and 'hybrid' financial institution, the mutual fund regulations of SEBI appear inappropriate in respect of UTI. It, therefore, appears desirable that UTI be given certain special dispensations in recognition of its special character. We would request SEBI to work out an appropriate set of dispensations in recognition of its special character. We would request SEBI to work out an appropriate set of dispensations with UTI."

The regulatory framework for UTI that became operative from 1.7.1994 on the Ministry's initiative was a 'voluntary' compliance of the SEBI (Mutual Fund) Regulations by the UTI for all the schemes launched after that date (which, therefore excluded the US-64 scheme). The arrangement was voluntary and not statutory or mandatory because full compliance with SEBI regulations required amendment of the UTI Act. Therefore, even for the schemes coming under voluntary arrangement, SEBI did not take any action against UTI for violations.

Subsequently, the Ministry of Finance informed SEBI *vide* its letter dated 10.11.95 that

"...the Committee on Government Assurances of Rajya Sabha felt that the arrangement worked out by SEBI for UTI has to have a legal sanction as otherwise it may not be enforceable."

SEBI, in its reply to the Ministry stated that the UTI had to be restructured and this could be achieved by amending the UTI Act because SEBI regulations being in the nature of subordinate legislation could not override the UTI Act. Through communications dated 29.2.96, 26.6.96, 22.11.96, 30.4.97, 13.10.98, 17.3.99 and 26.4.99, SEBI pointed out the need for UTI schemes to be statutorily brought under its purview, the need for restructuring UTI to bring it in line with other mutual funds and the need to amend the UTI Act if necessary, for this purpose.

- (v) The matter of amending the UTI Act was again taken up by the Governor, Reserve Bank of India wrote to the Finance Secretary on 2.1.1995 suggesting the deletion of Section 10 (aa) of the UTI Act, which provides for a nominee of the RBI on the Board of Trustees. The Finance Secretary in his reply dated 16.2.1995 indicated that while the Ministry had no objection to dropping Section 10 (aa) of the UTI Act, it would be appropriate to consider other required changes in the UTI Act at the same time. These were
- (a) Doing away with the role of appointing four trustees on the Board of UTI by IDBI, in the context of change of role of IDBI *vis-a-vis* UTI with the emergence of IDBI as a competitor to UTI.
  - (b) Replacing the Executive Committee of the Board of Trustees by an Asset Management Company (AMC) that normal mutual funds are required to have.
  - (c) No member of the Board of Trustees would be a member of the AMC and vice versa except the Chairman.

RBI's views on these specific changes were sought. The Governor, RBI conveyed RBI's suggestions *vide* letter dated 15.3.1995. The letter stated that in the present context of changing role of IDBI *vis-a-vis* UTI, RBI agreed with the suggestion that it would not be appropriate for IDBI to have such a dominant role in UTI. It was suggested that IDBI's share in UTI could be reduced and transferred to a disbursed ownership by a large number of public sector banks and financial institutions and in that event the Government could have a directly have a nominee on the Board of Trustees, if it so desired. The RBI also agreed with the idea of replacing the Executive Committee of Trustees by an Asset Management Committee patterned on SEBI guidelines. Further, Chairmanship of the Board of Trustees and the Asset Management Committee should not be a common one and the Asset Management Committee could be headed by one of the executives of the UTI. There should be clear delineation in the role and functions of the Board of Trustees and Asset Management Committee. The letter also mentioned that it might be necessary to make suitable changes in various provisions of the Act wherever IDBI had been empowered to decide matters concerning UTI. The letter suggested that along with these amendments, Section 10 (aa) regarding an RBI nominee on the UTI Board of Trustees could also be deleted as proposed earlier.

- (vi) On 22.4.1995, the Finance Secretary wrote a letter to Chairman, UTI regarding restructuring UTI and mentioning the proposals discussed in the earlier correspondence with RBI. Specifically, suggestions regarding deletion of Section 10 (aa) of UTI Act to do away with RBI's presence on the Board, review of IDBI's role in the management of UTI, reduction and dispersal of the initial capital of UTI from IDBI to other institutions, appointing a government nominee on the Board of Trustees directly rather than by RBI, amendment of UTI Act to provide for an AMC and separation between AMC and Board of Trustees were conveyed in this letter. The Ministry of Finance asked UTI to submit a proposal for a suitable legal structure for UTI in consultation with SEBI to the government for discussion in the High Level Committee on Capital Markets within the next two months. This letter was endorsed to Governor RBI, Chairman SEBI and IDBI.

Chairman, UTI responded to this letter *vide* letter 26.5.1995 stating that a detailed note on the subject was being prepared by the UTI Management for consideration by the Board of Trustees and that UTI would consult the Government, SEBI, RBI and IDBI before formulating a scheme for restructuring UTI. The Ministry of Finance sent an Office Memorandum dated 20.6.1995 to the Governor RBI, Chairman SEBI, Chairman IDBI and Chairman UTI requesting suggestion for a suitable legal structure for UTI to be sent at the earliest. The Ministry sent another reminder to Chairman UTI on 28.6.1995 asking UTI to expedite its specific proposals so that the matter could be discussed in the High Level Committee on Capital Market.

- (vii) The Governor, RBI *vide* letter dated 1.1.1996 to the Secretary, Ministry of Finance, responded to the request for suggestions and gave some further suggestions besides those on ownership and Board of Trustee representation which had already been addressed in RBI's earlier letter. RBI expressed concern about some of the activities allowed under the amended s. 19 of the UTI Act, as these activities like granting of loans and advances, accepting, collection and discounting, rediscounting of bills, etc. were akin to the activities of banks and term lending institutions and were not allowed for other mutual funds. RBI pointed out that these activities were not provided for in the original Act but had been allowed by an amendment in 1985 and that these activities often resulted in the attenuation of credit discipline. RBI therefore

recommended that these activities as well as the power of UTI to borrow from RBI should be deleted from the UTI Act to bring its functions in line with those of a pure mutual fund.

- (viii) Despite reminders from the Ministry, the then UTI Chairman failed to forward UTI's suggestions regarding restructuring of UTI and amendment to the UTI Act. In a letter dated 13/2/1996, to the new Chairman Shri Jagdish Capoor, the Ministry of Finance referred to its earlier letters and stated that despite the letters being acknowledged by the former Chairman, UTI's proposals had not reached the Ministry within the period of two months and that no communication had been received from the UTI till date. It was requested that UTI should expedite its response. Another letter dated 27/3/1996 was sent to the Chairman UTI by the Ministry strongly suggesting that the issue of restructuring UTI be brought up at the next meeting of the Board of Trustees in the light of deficiencies in UTI's mutual fund schemes pointed out by SEBI in its inspection report.
- (ix) Finally, Chairman UTI wrote to the Finance Secretary on 18.10.1996 informing him that the UTI Board of Trustees had considered a proposal for the restructuring of UTI and as the proposal approved by the Board envisaged a possible repeal of the UTI Act, he was writing to seek governments approval on the matter so that consequential details could be worked out. The letter outlined a comprehensive plan to restructure UTI. A federal structure was proposed in which a parent organisation would own all business units and provide these units with strategic direction, top managerial resource support and synergetic integration as well as evaluate their performance. The parent organisation would own investments in all of UTI's subsidiaries and also in those organisations where UTI had substantial shareholding as a promoter. The parent organization would also sponsor a mutual fund by setting up and investing in an Asset Management Company and a Trustee Company, in accordance with SEBI's Mutual Fund Regulations. All existing schemes of UTI would be transferred to the Asset Management Company for management and it would also launch new mutual fund schemes in the future. The Board preferred that the parent organisation and the Asset Management Company be incorporated as a company under the Companies Act. It was tentatively proposed that of the parent company's initial capital, 40% would be contributed by a group of clearly identified financial institutions and banks and the remaining 60% by other financial institutions and banks, and non-banking financial companies and also in due course, members of the public. In addition the existing Development Reserve Fund (DRF) of UTI constituted under the UTI Act would be transferred to the parent company. The parent company would have a professional board; the Chairman and the Non-Executive Directors of the parent company would be appointed in accordance with the provisions of the Companies Act. Executive Directors on the Board would also be professionals to be appointed by the Chairman and the Non-Executive Directors. The parent company would earn income from its investments and would therefore be akin to an investment company also acting as a sponsor to the mutual fund schemes being managed by the Asset Management Company. If the government desired to have ownership in the parent company, the Board recommended that it should not own 49% of the equity and the parent company should preferably be constituted as a non-government company. It was also suggested that those schemes being managed by UTI which had strong social welfare content as also medium and long term saving schemes such as Monthly Income Plans and US-64 Scheme should continue to be managed by the Asset Management Company as any contrary view might create an organization vacuum for similar schemes in future besides commercially injuring UTI's present composite

activity. This would therefore require regulatory recognition from SEBI through amendments to the mutual fund (general) regulations. The letter concluded by stating that once the Government had indicated its acceptability to these restructuring proposals, consequential details including the amendments to the UTI Act could be worked out by UTI.

The Ministry of Finance requested that UTI make a presentation on their restructuring proposal on 5.12.1996. UTI has stated that they have no records of the presentation or of any subsequent developments relating to this presentation. RBI has informed the Committee that as per the records available with the Reserve Bank, the matter was not formally brought before the High Level Committee on Capital Markets. The Ministry of Finance is silent on this and merely states that it was generally recognized that it would take UTI some time to make its various schemes compliant with SEBI guidelines.

- (x) The Ministry of Finance's recitation of events as well as its files reveals that between 1997 and 1998, there was no further movement to restructure UTI or amend the UTI Act.

The Deepak Parekh Committee on the US-64 scheme set up by UTI, submitted its report on 25.2.99 made the following recommendation,

"The Committee strongly believes that the management structure of US-64 should be brought in line with those of other mutual funds. To achieve the foregoing, the Trust should create a separate Asset Management Company for US-64 with an independent Board of Directors, which would be responsible for the overall supervision. At least 50% of the board should comprise of independent directors. This requires an amendment of the UTI Act. Pending the amendment, the Asset Management Committees should be re-constituted (to include independent experts) and their roles and responsibilities clearly defined."

RBI again sent a letter dated 6.10.1999 reminding the Ministry that RBI had been requesting for amendments to the UTI Act and deletion of section 10(aa) which provided for nomination of a Trustee by RBI on the Board of Trustees of UTI which had not yet been done. The letter pointed out that the High Level Expert Committee (Deepak Parekh Committee) on US-64 had recommended, *inter alia*, certain amendments to the UTI Act and suggesting that the dropping of section 10(aa) be considered while drafting amendments to the UTI Act. It was only then that the Ministry in December 1999 renewed correspondence with the UTI and asked it to make a presentation about restructuring and amendment/repeal of the UTI Act, following which a committee comprising representatives from UTI, the Ministry of Finance (Department of Economic Affairs) and others, as required, could go into the framing of amendments to UTI Act. UTI made a presentation on 1.5.2000 in which it was proposed that one way of restructuring UTI would be to repeal the UTI Act and set up a holding company which would float subsidiaries for mutual funds, banking etc. For the mutual fund it would sponsor an Asset Management Company and a Trustee Company. These proposals were essentially similar to UTI's proposals of October 1996. After consultation with the Ministry, another Committee was set up by the Board of Trustees of UTI in July 2000 under the Chairmanship of Shri Y. H. Malegam to review UTI's competitive position and recommend legislative amendments to enable UTI to fulfil SEBI guidelines and enhance its competitive position. The UTI crisis involving the freezing of US-64 redemptions happened at the same time. Malegam Committee's recommendations are discussed in Chapter XXI.

20.4 When asked whether he was aware that the Finance Secretary had written to Chairman UTI in April 1995 proposing review of UTI's structure and amendments to the Act to be discussed in the HLCC and that the issue had subsequently not been taken up in HLCC, the then Finance Minister, Dr. Manmohan Singh has stated,

"Mr. Chairman, Sir, a lot of rethinking took place. In fact, if you look at the whole history of the financial sector reforms, there is wealth of ideas which were discussed during the period 1991 to 1996, and I venture to think that subsequent five years have seen only either implementation or elaboration of those ideas. It was very much in our mind that in the changed circumstances, the Unit Trust of India needed a different management structure but in all this, we wanted to move forward with the fullest possible consent of all concerned authorities. There were differences between SEBI and the Unit Trust of India. I resolved them half way in the sense that I said, "Pending the decision on the future of UT-64 scheme, all the new schemes of the Unit Trust of India would be subjected to SEBI examination." In the same way, as to who should sit on the Board of Directors, originally until 1976, it was the Reserve Bank, which had 50 per cent of the share of the Unit Trust of India, and, therefore, in the Unit Trust four nominees came from the Reserve Bank of India. After the separation of IDBI from the Reserve Bank of India, IDBI assumed that role and even the Government nominee used to be nominated *via* IDBI route. We felt that in the changed circumstances, when there is going to be more competition among various financial institutions, and UTI and IDBI would emerge as competitors and it was, therefore, necessary to relook at the management structure, the Board of Directors. All these issues were discussed with the Reserve Bank of India. All these issues were discussed with the Unit Trust of India. But my concern was that nothing should be done to hurt the Unit Trust of India which in many ways was a unique institution. I had opened up this new route of bringing foreign institutional investors into our stock market. I did not want to do anything in haste which would hurt the Unit Trust of India. It is while opening up our economy to foreign institutional investors, I was keen that we should not weaken the UTI, an institution in our own country which would have inherent strength to exercise a countervailing power. The Unit Trust of India had hesitations about large scale restructuring being attempted. So we decided to go in that direction step by step. If you look at the file, I think, in 1995 there was an extensive discussion about restructuring of the UTI between the various entities, the Securities and Exchange Board of India, the Unit Trust of India, the Reserve Bank and the Ministry of Finance but we could not bring that discussion to a fruition because there were, I recall, differences of opinion and I did not want to hurt the Unit Trust of India in any way. Mr. Chairman, you will recall that after the 1992 security scam, the capital market was down, and the Unit Trust of India is a big player in our capital markets. I wanted to reform the Unit Trust of India in a manner which would not create doubt about its intrinsic viability. That took time because there were differences between the management of the Unit Trust of India and rest of us. So that led to some delay in the whole process of restructuring. But many ideas were discussed and elaborated in discussions that our officials had with the officials of the Unit Trust of India."

The then Finance Minister Sh. P. Chidambaram was asked whether he was aware of Chairman UTI's letter dated 18.10.1996 proposing restructuring of the UTI and possible repeal of the UTI Act, the MoF's invitation to UTI to make a presentation on the matter and MoF's subsequent silence on the issue, Sh. P. Chidambaram has confirmed that though the letter had not come to his notice and had not been discussed with him he was aware that proposals were discussed at the officers' level for restructuring the UTI and the UTI Act. Explaining why he had not pursued the matter of amendment of the Act during his tenure he stated,

"Today, with the benefit of hindsight, the UTI occupies so much of time and attention. But in the Government of India, the Ministry of Finance as well as the Ministry of Home

Affairs are such large Ministries, the critical always overtakes the urgent. At every level, we have very senior officers dealing with this matter. It is impossible for any Minister—I am sure you will bear me out, and others will also bear me out when their turn comes—to follow every letter. The point is that if a question has to be asked, the legitimate question, you must ask the Finance Secretary what did he do on that request for presentation...”

20.5 The Committee conclude that between 1992 and 1996, the Ministry had identified the need to delink UTI's mutual fund activities from its term lending activities, the need to bring UTI's mutual fund activities under SEBI regulations, the need to do away with IDBI's role in UTI and the consequent need to amend the UTI Act. The Ministry's own view regarding the need to amend the UTI Act also had the mandate from Parliament as well as the backing of the Central Bank and the Capital Market regulator. Only the top management of UTI was reluctant to amend the Act and restructure the institution, and the Ministry indirectly supported the *status quo* in UTI by implementing interim measures in 1994 like UTI coming voluntarily under the regulation of SEBI since statutory regulation by SEBI would have required an amendment of the UTI Act.

The Ministry had subsequently decided to discuss comprehensive proposals regarding restructuring UTI and amendment of the UTI Act in the High Level Committee on Capital Markets and sought UTI's proposal on a suitable legal structure for UTI but the UTI management was not convinced about the need to restructure and failed to act on this. It was only in 1996, with a change in the top management of UTI that it agreed to restructure itself and sent a comprehensive proposal to the Ministry in October 1996 that involved possible amendment of the UTI Act. However, now that all stakeholders were agreeable to restructuring UTI and an amendment of the UTI Act, it was the Ministry that strangely fell silent, took no further action on UTI's proposal and did not place it before the High Level Committee on Capital Markets.

RBI reminded the Ministry of its organisational and statutory obligations in October 1999. The Ministry again decided to pursue amendments to the UTI Act by interacting with UTI after which UTI appointed the Malegam Committee, by which time the crisis in UTI became public.

The mandate regarding the organisational matters of UTI and the administration of the UTI Act lies with the Capital Markets Division in the Department of Economic Affairs of the Ministry of Finance. The failure of the Ministry to push amendments to the Act between 1993 and 2001 despite identifying the organizational and statutory weaknesses in UTI reflects poorly on its functioning. There seems to have been a reluctance to push UTI although other stakeholders were convinced about the need for restructuring. Even when UTI management had agreed to restructure the institution, the matter was not taken to its logical conclusion, which reflects a degree of institutional amnesia and a lack of urgency with no system of setting any deadlines by which certain actions were to be taken. This resulted in matters being delayed inordinately by in depth discussions, which were not followed up by action on the ground. The Committee are of the view that this malaise in the Ministry needs to be urgently addressed by reviewing the administrative decision-making mechanisms in the Ministry.

## **B. INTERACTION BETWEEN MINISTRY OF FINANCE AND UTI**

20.6 Under the UTI Act it is the IDBI (a Public Financial Institution) and not the Central Government, which has powers to call upon UTI to furnish such information as it may require, to give UTI written directions by which it is bound and to give prior approval to UTI for appointment of auditors. While in the case of other public financial institutions like IDBI, the annual accounts and balance sheet together with a copy of the auditor's report and annual report are furnished to the Central Government and thereafter placed before Parliament, UTI balance sheet is only published in the official Gazette of India. Also, the Central Government does not have the

power to appoint the Comptroller and Auditor General of India to examine the accounts of UTI like it does for IDBI. IDBI also had the right to nominate four trustees to the Board of UTI.

For at least a decade or more, the Ministry of Finance had direct representation on the Board of Trustees of UTI even though this was not provided under the UTI Act as one of IDBI's nominees always used to be an official from the Ministry of Finance, usually the Joint Secretary in the Capital Markets Division. It was only between 2.5.1997 and 20.7.2001 (a period of 3 years and 2 months) that the MoF took a conscious decision to do away with this practice with the approval of the then Finance Minister in order to give more autonomy to UTI in its functioning. Even when a MoF nominee was on the Board of Trustees of UTI, there was no practice of the MoF nominee automatically submitting reports on UTI Board Meetings from 1994 onwards. There has also been no practice of UTI sending regular reports like monthly reports to the Ministry on its Board meetings or any other issues. The notings in the Ministry's file on this issue show that the Ministry had first proposed in 1994 that the MoF nominee on the Board of Trustees of UTI be withdrawn and this position was endorsed by the Finance Secretary but not agreed by the Finance Minister though no reasons were recorded on file for this decision. The Ministry again took up this issue in 1997 and recommended that the MoF nominee on the Board of Trustees of UTI be withdrawn for the reasons that statutorily there was no such provisions in the UTI Act, it would be inappropriate for a government nominee to sit on the Board of an institution where decisions regarding investments on a continuing basis were being made, the Government was planning to give further autonomy to SEBI and UTI were in dialogue for effecting its restructuring and that the Capital Market Division was also dealing with sensitive issues as certain papers from the CBI and SEBI regarding functioning of UTI were being examined, so there would be a conflict of interests if an official from the Division was also a member of the Board of Trustees of UTI. The Finance Minister agreed with these views and the MoF decided to withdraw its nominees from May 1997. Thus conscious decisions were taken in MoF in 1994 to have a nominee via IDBI, withdraw their nominee in 1997 and reinstate him in 2001.

20.7 Sh. P. Chidambaram, who as Finance Minister took the decision to do away with the practice of having an MoF nominee on the Board of Trustees of UTI has told the Committee that,

"I believed then and I believe now, it is no part of the Government's function to put its 'man' on the Board of UTI and virtually dictate the agenda to the management of UTI. In fact, if you read the UTI Act closely, as I am sure hon. Members have read, it was set up by an Act of Parliament but all the powers, which normally Government enjoys, were given to the IDBI including the power to give direction under Section 30 of that Act. The Ministry of Finance representative was, in fact, smuggled into the UTI through the IDBI route. So, it was really not a representative of the Ministry of Finance and I believe that was not the correct thing to do. One must give autonomy to UTI and UTI must be accountable to Parliament and to the people and to the Government. But you should not have a Joint Secretary level officer sitting on the UTI Board. If that happened, my experience is that the management tends to look to the Joint Secretary for crucial decisions; the Joint Secretary then tends to look to his Secretary for crucial decisions; and eventually, it is the Ministry of Finance which is running that institution without understanding the day-to-day problems of running an institution. That would have been quite retrograde. I think the correct decision was to say that we are not appointing any of our officers and you please appoint members to the Board of Trustees in accordance with the UTI Act. In fact, that decision was not reversed by the successive Governments for at least three to four years."

Shri Yashwant Sinha, in whose tenure it was decided to restore the MoF nominee has informed the Committee that,

“The consideration which weighed with me in reversing this decision in the light of advice to the contrary from the officials of the Ministry was that the management of the UTI, and perhaps even the professional Board of UTI, could not be fully trusted and that we needed a person in the Board who would keep the Ministry informed of the goings on, on at least as regular a basis as the Board meetings are held. ”

20.8 As detailed in Chapter XVII and Chapter XX, UTI paid dividend in excess of its income for the year for four years in succession from 1994-95 to 1997-98. On being asked whether it was in his notice during his tenure that UTI had paid high dividends in 1994-95 and 1995-96, the then Finance Minister Dr. Manmohan Singh stated that,

“First of all, I should make it clear that I did not sit in judgement on the decisions of the Unit Trust of India as to what rate of dividends they would be paying. I did discuss this matter once or twice with our officials because the Ministry of Finance has an official on the Board of Directors of the Unit Trust of India. If I remember correctly it was in 1994-95 that the Unit Trust of India first raised the dividend by dipping into the reserves. When questioned, our officials told me that the UTI expected the market to behave in a particular manner and the UTI was confident to sustain the dividend rate. UTI was also keen to sustain the attractiveness of units for purposes of investment. It was entirely appropriate as a short-term strategy but not as a long-term strategy to dip into the reserves. All over the world, I believe, companies do dip into reserves at times to sustain dividend payments at a level considered realistic in the medium term.”

Shri P. Chidambaram, during whose tenure UTI paid high dividends in 1996-97, has stated that,

“This was a decision of the Board of Trustees. *Post facto*, I knew about this decision. In fact, it was in the newspapers the next morning before it officially came to me. ...For the Board of Trustees to think that they could live with that YOI and at the same time satisfy 20 million investors, I am not going to second guess that decision. It was not my function and I did not second-guess that decision.”

He also pointed out that the dividend of 20% declared in this year was lower than the previous years dividend of 26% and added that,

“...In fact, I remember, at the next opportunity I did tell them that they were moving in the right direction by lowering dividend from 26 per cent to 20 per cent. It is quite possible that the Board of Trustees decided that a sharp decline from 26 per cent to 15 per cent might upset the investors and upset the market. I think, the gradualism was a right approach and in no way is it a part of the Finance Minister’s functions to second guess the decision of the Board of Trustees.”

20.9 Regarding the fact that the equity portfolio of US-64 scheme had changed from predominantly debt to predominantly equity, Shri P. Chidambaram has stated that,

“...when the equity part of the investment was rising, I remember, I did point out that this has to be controlled. I think, in the year in which I was in office, it was brought down by a few percentage points. Then, I think it was brought down again. Then, it started to rise.... The UTI Management Board of Trustees did not keep a close watch on the mix of the portfolios. They allowed the equity part to rise. They should have kept it under control

especially when they were floating a number of assured income schemes. More than that, they had a huge body of US-64 investors who regarded it as an assured income scheme which it was not. We have encouraged people to believe that it is an assured income scheme. They should have been a little more careful”

20.10 Regarding the fact that over the years UTI's US-64 portfolio subscriber profile had also changed from the small investor to corporates, Dr. Manmohan Singh has stated that,

“This matter did come up before me. If I remember correctly, in consultations with the management of the UTI, certain decisions were taken to reduce the excessive reliance on corporate funds. I did point out—though, I have not seen the relevant file—but I do recall from memory that I did mention it to the UTI management. The UTI was created essentially to help the small man. Mobilising funds from the corporate world, having surplus liquidity and claiming credit for that, was not the original purpose.

20.11 Commenting on the consortium lending process which caused NPA's in UTI and other financial institutions, Dr. Manmohan Singh stated that,

“But my own feeling is that in the name of coordination, we should not create structures which are over-bureaucratic, over-centralised. For example, take the case of consortium lending. At one time, it was a good thing because it required collective application of mind with regard to viability of projects, and the task of management was also greatly simplified after a project and its financing had been approved by the Inter-Institutional meeting. But one consequence was that not enough attention was paid to developing techniques of risk management. It led to a lot of lethargy in the functioning of many of our financial institutions. If—right from the beginning—our financial sector managers was trained to deal with risk management, I think, Indian financial system today would have been much stronger in dealing with the world of uncertainty than it is today.”

20.12 The role of the Ministry of Finance leading up to the suspension of sale and purchase of units in the US-64 scheme in July 2001 has been discussed in Chapter XVII. The Committee discussed the matter at length with the then Finance Minister Sh. Yashwant Sinha. Asked under what circumstances he had stated in the Rajya Sabha that he was kept in the dark, Shri Yashwant Sinha stated,

“...I had stated in the course of the debate in the Rajya Sabha that when I saw the Press reports during the months of May and June that all may not be well with the UTI and US-64, I made enquiries about the situation. I mentioned this to the then Finance Secretary and suggested to him from time to time that this matter should be enquired into from the UTI management and we should find out as to what exactly was the situation. I also said in the Rajya Sabha that I was assured repeatedly—not once or twice, but whenever I made such enquiries—that the management of the UTI had been contacted and the Ministry had been assured that they were capable of dealing with the problem and that there was nothing really wrong. Therefore, the Ministry need not be worried too much on this count. I also said in the Rajya Sabha that when I was assured in this manner, then what was it that was expected of the Finance Minister? It is on the record of the Rajya Sabha. I said, ‘was I expected to take the first flight to Mumbai, go chagrining into the office of the UTI and say to them that I do not believe you? I want to see all your papers, please tell me what the state of affairs is?’ This is what I said in the Rajya Sabha. I have said in the reply to the questionnaire that was sent to me that therefore the Ministry was kept in the dark. Today in the course of my preparation for this appearance before the JPC, I was looking for a letter that the then

Advisor to the Finance Minister had written in July, 2002.... This was addressed to the Finance Secretary Dr. S. Narayan. Because there was a question relating to this in the Questionnaire, I obtained a copy of this letter. It is very relevant. Even I was not aware of it. In this letter, on page 2, last but one paragraph, he says: "I satisfied myself that the UTI Board papers, which were sent to me during the period January to May 2001, did not provide any information that would have suggested the problems that emerged later." This is what Dr. Rakesh Mohan says. Subsequently he joined me as Advisor in January 2001, and formally resigned from the Board of Trustees in May, 2001. During this period, Board papers were being sent to him and this is the assertion that he has made in this letter. When I said, Mr. Chairman, that the Ministry was kept in the dark, this is what I meant that at no point of time did the Chairman of the UTI come to the Ministry to tell us what the problems were; how could those problems be attended to; and how could we perhaps jointly work together to find the solution to any problem which was there. You are aware, Mr. Chairman, that at least in writing there is the letter of 18th May, 2001, and then there is the letter of 30th June, 2001. What happened to the 30th June letter is something which is already in public domain because this has been discussed in the Rajya Sabha and I had said what my position was. So, when I say that the Ministry and I were kept uninformed, or in the dark, I am not saying that this has happened because I was not proactively inquiring. This is an obvious misperception, which has persisted, as if I was sleeping always, unconcerned and, therefore, I was in the dark. No, Sir, my statement is that I proactively made inquiries. I wanted to know what the facts were, what the situation was, and it was only that every time I was told that the things were all right, that there was nothing to worry until the letter of the 30th June, which came like a bolt out of the blue for every concerned."

Asked whether he had thought it necessary to question the two assumptions in Chairman UTI's letter dated 18.5.2001, which was put up to him as a Fresh Receipt (FR), in which the Chairman had predicted the viability of US-64 based on a rise in the sensex by 22 to 25% by end June and a sensex level of 4300 at that time, Shri Yashwant Sinha's reply was,

"I would like to answer this question in two ways. First of all, then Chairman of the UTI was considered, and should have been, an expert in the behaviour of the stock market; I was not. I do not think I was competent enough to question his assessment of the market. Secondly, it was not unusual for the market to rise given certain situations, just as it was not unusual for the market to come down given certain situations. So, he made a judgement. ...I only read that letter as an FR, for information. As I have said in my reply, the letter was put up to me as an FR. It was not dealt with on the file, all these assumptions analysed, the Ministry coming to a conclusion; and then the file was put up to me. The letter came perhaps to a Joint Secretary. He put it up to the Secretary, who put it up to me. Then it went back to the lower levels. ...there are two ways of dealing with it. One is, immediately if you want to bring something to the notice of the Minister, you put it up as an FR. The second is, you deal with it on file and then expect the Minister or whoever is the final authority to take a final view in the matter. But this letter was put up to me as an FR, as a Fresh Receipt, for information. I went through the letter and returned it. When I looked at the assumptions in the letter, there was nothing fairly dramatically unusual about it so that I could have immediately questioned all the assumptions and said that this is my view; this is not correct and this is not likely to happen."

He also clarified that,

"The Minister does not say 'please examine it and put it up one file', unless the letter is addressed to the Minister. If a letter comes to me, I will say 'please put up on the file';

please examine and put'. If that letter is addressed to an official and that official is putting it to me by way of an FR, then it goes down. It is incumbent on the Ministry to examine it and put up."

Asked about the steps, which he had personally taken, between March and June 2001 to assess the impact of the steep fall in the stock market on the prospects of US-64, Shri Sinha stated,

"Any mutual fund which operates in the stock market is not necessarily affected in a major way merely by the fluctuations in the stock market. It depends on the kind of stocks they are holding when they are buying and selling. That will determine their profitability or lack of profitability. This is almost a daily operation. I do not think that it can be construed to be a part of the responsibility of a Finance Minister that he should look into the daily fluctuations of a certain scheme of UTI. UTI ran almost 100 schemes. To find out what exactly was the daily situation in every scheme is not the responsibility of a Finance Minister. It is for the UTI to see it. I have said it in reply to the questionnaire. As a Minister responsible to Parliament, we must also recall the UTI Act. We did not have a representative on the Board since 1997. It was a deliberate decision of the then Minister for Finance to withdraw the representative so that the UTI could function as autonomously as possible. Secondly, the UTI is not required to submit its account to Parliament. It is not required to be audited by the CAG. Therefore, I would like to make the plea here that there are institutions and each institution's responsibility to Parliament should be defined and is defined in terms of the Act. Here, the Government of India does not even have the authority to issue directives to UTI like it has with regard to many public sector undertakings. That authority is vested in the IDBI and therefore, to think that the UTI was an organization where the Government should have been interfering almost on a daily basis, I think, will not be correct."

Asked about the Ministry's role in monitoring the US-64 scheme since it was not under the capital market regulator SEBI, Shri Sinha's reply was,

"Unit 64, hon. Member is quite right, is not SEBI compliant scheme and therefore it was not being regulated by the SEBI. It was being managed by the UTI directly. For instance, when in 1998 there was a problem with US-64, this question was gone into in some detail and the Deepak Parikh Committee was appointed by the UTI Board to go into these questions. They had submitted a Report and that Report was studied by the UTI Board. Since there were some Government decisions involved, the Government also looked at that Report. Then, we kept following up on the implementation of that Report. That is how the Ministry was keeping in touch with the UTI as far as the Deepak Parikh Committee recommendations were concerned but the primary responsibility for making prudent investments of not only US-64 but also of the funds of UTI, which were the depositors' funds rested with the management of the UTI and the Board of Trustees as a professional body. IDBI had the authority to nominate, if I am not mistaken, up to four nominees on the Board of Trustees, and apart from one representative from IDBI directly, there were others who were supposed to be experts in the field. So, it was in a way a professionally managed company, UTI, which was supposed to take the most prudent decisions as far as investments were concerned."

Asked whether as Finance Minister when he became aware from the media reports for months together about stocks favoured by Ketan Parekh, the stock markets becoming very volatile and the type of investments that UTI had been making, he had done anything on his part, Shri Sinha's reply was,

"It is a very valid question. I think, I have tried to answer it earlier. I had said that I did come across such news reports. They not merely related to K-10 stocks and all that but

they also related, for instance, to large redemptions from US-64, especially in the month of May. These reports did disturb me and when I said that I made enquiries and told the then Finance Secretary that he should find out what was happening to the UTI—I also made a statement in Rajya Sabha—this is what I meant, that I came across news reports. And every morning when I read those reports, I went to the Ministry and asked the Officers to find out what was happening. Also, additionally the point which I was making was that every two or three days, suppose for instance I read a report today and three days later I read another report and I made enquiries, and three days later they will say, “We made enquiries about the earlier report and we have been told by the UTI that there is nothing to worry.” So, this was the kind of enquiries that one was making; one was aware of such reports appearing in the pink papers and other papers. It was not that I ignored them, I did make enquiries.”

Asked why after government had given assistance to UTI’s US-64 scheme in 1998, the Ministry had not heeded the earlier warning and found out what UTI was doing with the US-64 scheme, Shri Sinha replied,

“Sir, as far as the UTI is concerned, a number of committees had gone into the functioning of the UTI from time to time. I recall to mind, for instance, the Vaghul Committee which had looked into the functioning of the UTI earlier and had made some very important recommendations. Then, when the problem arose in the UTI in 1998, the UTI Board, as I have said, appointed the Deepak Parekh Committee which went into the functioning of the UTI and the Deepak Parekh Committee came out with a number of recommendations. I think, it made 18 or 19 recommendations. As I said earlier, some of these recommendations had to be implemented by the Ministry of Finance, by the Government. While framing the Budget of 1999, we took on board the suggestions which had been made in terms of tax benefits and provided for that. The Ministry kept regularly in touch with the UTI with regard to the implementation of the Deepak Parekh Committee recommendations and there was, in many cases, a time-frame which was provided for the implementation of those recommendations by the Deepak Parekh Committee itself. For instance, one such recommendation was of changing the nature of the portfolio of US-64 from being heavily equity oriented to being a balanced fund and increase in the share of the debt instruments. This had to be done over a period of time because this is a kind of thing which could not have been done in a hurry. So, in respect of the general health of the UTI, in respect of the Deepak Parekh Committee’s recommendations, the Ministry did keep in touch with the UTI. There is correspondence in the Finance Ministry’s files to show this. The issue here is the crisis which overtook US-64 in early July, 2001, and it was with respect to that, that I have been saying from the time I became aware of the crisis that not only did the UTI management not keep the Ministry of Finance properly informed, but even with respect to the enquiries which were being made by the Ministry of Finance, they painted a picture which was, perhaps, very, very different from what was contained in their letter of 30th June. When I say that this was how they kept the Ministry of Finance in the dark, this is what I had meant. I had just read out from Dr. Rakesh Mohan’s letter to emphasise the point that in none of the Board papers, up to the month of May, did they come out with the true state of affairs. It was, obviously, something which the management was keeping to itself until the 30th of June, when they decided to go to the Board of the Trustees of the UTI with the proposals which are contained in that letter which he wrote to the Finance Secretary on the 30th of June. I have just responded to the question ...asked ...by saying that I read disquieting reports in the media and it was that which prompted me to make enquiries. But even these enquiries did not reveal the true state of affairs because obviously, the management of UTI kept giving us a different picture. So, I should say that there was

nothing at all to suggest that UTI was going to face such a serious crisis with regard to US-64 that they will have to go for a freeze of redemptions for six months or so, which is what the Board ultimately decided on 2nd July, 2001. This is how this part is explained."

Asked whether he agreed that the officials of the Ministry of Finance had failed in their responsibilities of making proper enquiries, Shri Sinha's reply was,

"I think, to the best of my judgment, it will be wrong to blame the officials of the Ministry of Finance because the officials of the Ministry of Finance kept in touch either at my behest or on their own with the management of the UTI. They were informed that there was no reason to worry and that things were under control. This is what they reported to me."

Asked whether they were wrong in giving such a report, Shri Sinha stated that,

"We cannot say that unless there are facts to the contrary. There are some facts which, for instance, I have shared with the Rajya Sabha. I have made the point that redemptions took place in the month of April/May, and what was it that caused the problem. It was not merely the decline in the stock market; it was the heavy redemption that took place especially in the month of May. I have shared the facts and figures in the Rajya Sabha debate that in the month of April, the redemptions were, let us say, to the extent of Rs. 400 and odd crore, of course, this is subject to correction, it is on the record of Rajya Sabha, but in the month of May, the redemptions went up to Rs. 3,400 crore or Rs. 3,600 crore. Now, if those redemptions had not taken place, the financial health of US-64 would not have declined. Was it not something which should have been brought to the notice of the Ministry that such heavy redemptions were taking place? Even in the letter of 18th May, the Chairman does not talk about redemptions. Throughout the month of June, the Chairman did not talk of redemptions. Nobody in the UTI management brought this problem to the notice of the Ministry."

Asked why the Ministry still remained in the dark when after the experience of 1998 it was the duty of Capital Market Division in the Ministry to hold periodical reviews about the net asset value and the redemption liability of US-64, Shri Sinha's replied that this was because repeatedly the Ministry was told by UTI that there was no problem. He added that,

"...Here is an organization, here is a Chairman who is telling with the fullest confidence that there were no problems. We have the letter of the 18th May where he has made certain assumptions and still on the 18th of May he is saying that there was no problem."

**20.13 Though the government's responsibility for UTI was not written into the UTI Act, 1963, its accountability for UTI's US-64 scheme to Parliament became obvious when the scheme was kept out of the purview of the market regulator. After the recent legislation repealing the UTI Act of 1963, its accountability for US-64 and UTI's assured return schemes has become explicit. Successive Ministers of Finance have confirmed to the Committee that they took care to keep themselves informed of matters affecting UTI in general, US-64 in particular, and activities in the capital markets that could have a bearing on the financial health of UTI and its several schemes. The crisis in UTI in 1998, including its impact on US-64, led to a pro-active role by government in assisting UTI to recover its financial feet. It also provided the opportunity for interaction between the Ministry and UTI to sort out several issues pertaining to risk management, unit holder protection and asset management. Regrettably, negligent management by UTI and inadequate monitoring on these fronts contributed in significant measure to the crisis in UTI generally and US-64 in particular which led all issues relating to UTI being added to the terms of reference of the Committee in July 2001.**

20.14 The Committee observe that UTI was undoubtedly flush with large funds. The shape of UTI's investment portfolio and subscriber profile also underwent a change from its inception in 1964 to the present redemption problem. It has been stated by all the Finance Ministers that this Committee had the occasion to listen to that the Government did not want to interfere in the day-to-day working of UTI. The UTI Board consisted of eminent persons whom the Government considered to be quite competent to deal with the affairs of UTI. Whether the Government interfered too much in the affairs of UTI and influenced its decisions, or kept inadequate watch on the affairs of UTI and kept away from its responsibility, was something that the Committee considered very deliberately. There was also a variation in the view of the Government with regard to this aspect. The Government's nominee on the Board of UTI has always been through IDBI and not directly. While in 1994 it was decided to retain the Ministry of Finance nominee on the Board of UTI, in 1997 the Government decided that there was no need for any Government official to be on the UTI Board and that UTI should have full autonomy with regard to its functioning. Consequently, the Government representative on the Board was withdrawn on 1.5.1997. However, after the redemption problem and the debate in Parliament on the subject, the Government decided to again place its nominee on the UTI Board. The Committee are of the view that the communication between the Ministry of Finance and the UTI has been, over the years, very uneven and no management information system was formalised which could have given the Ministry some lead indicators of any trouble brewing in UTI's finances. The Committee feel that since the US-64 scheme was not subject to SEBI guidelines, was not NAV based, had a large investor base, held a huge stake in the equity markets and had been bailed out earlier, the Ministry of Finance should have been more pro-active in devising a formal mechanism like a monthly management information system about the US-64 scheme to be sent by UTI, so as to monitor its health. If such a system had been put in place, the Ministry of Finance would have been able to deal much more promptly with UTI, when the stock market showed volatility, the share prices fell steeply and the US-64 scheme faced liquidity problems due to redemption pressures.

## CHAPTER XXI

### FUTURE ROLE

21.1 The speech of the Finance Minister in Parliament on 4.12.1963 while introducing the Unit Trust of India Bill gives ample illustration of the reasons for setting up UTI, the role envisaged for it, the proposed benefits and the way it was to be run.

On the general need for unit trusts, the Finance Minister stated the following:

- (i) Unit trusts enable many individuals, who do not have the ability or inclination to buy securities or to operate in the stock exchanges on their own, to become part owners in industry or other corporate sector bodies carrying on a variety of activities.
- (ii) The unit trusts operate on the principle of spreading risks. The income or dividend which they declare is based on the average income on a balanced and well-distributed portfolio of investments. An ordinary investor, who does not have the resources for acquiring such a balanced portfolio, derives from a unit trust the advantage that many of the risks of investment are eliminated or reduced for him. The original investment is safe, because of prudent management. It is quite often increased, because of the appreciation resulting from the increased value of the industrial or other property represented by the investment. The ordinary investor is thus protected automatically against the erosion of the value of his investment because of the rise in the value of the base of these securities. These are significant advantages from the point of view of individuals who have some money to save and to invest.
- (iii) The distinction between an investment company and a unit trust is important in this connection. Broadly, it is that an investment company has a great deal of freedom in the matter of distributing the available income whereas in the case of unit trusts they are required to distribute the whole or practically the whole of their income every year.

He cited some specific reasons for establishing such an institution in India:

- (i) So far as we are concerned, the objectives behind the desire to create Unit Trusts in India are somewhat more complex than those that operated in the Western countries.

Investment in securities, for a person who is not well-versed in the operations of the money and equity markets, is not easy. Amongst the middle-classes, there are only very few who watch the share market or watch for investment opportunities. For one thing, the man who knows something about these things has not got the money and for another, the man who knows nothing about this is afraid to invest in securities not knowing what will happen to his money. The share market while it does play an important role in promoting investment reduces or drives away any desire on the part of persons in the middle and lower income groups to invest in securities because of the scares that are created owing to the operations by what are called bulls and bears.

- (ii) There is undoubtedly a much larger capacity for saving amongst the community and to produce any results in the shape of sizable amounts as savings made available for investment, we have necessarily to approach the middle and lower income groups rather than the comparatively small number of affluent people. The problem has to be attacked from several angles and by several instruments of Government's savings policy. The Unit Trust provides one such. It provides an opportunity for the middle and lower income groups to acquire without much difficulty property in the form of shares, the base of which is something which will not erode, but will appreciate in value as years go by.

21.2 He made the following specific points about the constitution, management and functions of the UTI as well why private institutions were not being allowed in the field:

- (i) The Unit Trust of India, as it is envisaged in this Bill, will be an organization in the public sector, sponsored and supported mainly by the Reserve Bank, the Life Insurance Corporation and the State Bank of India and its subsidiaries.
- (ii) "...the organization will be run solely in the interests of the unit-holders, who will be entitled, every year, to not less than 90 per cent of the net income attributable to the amounts invested by them in the form of units in the trust."
- (iii) It will be open to any person or institution to purchase the units offered by the Trust, but this institution as we see it, is intended to cater mainly to the needs of the individual investors, and even among them, as far as possible, to those whose means are small. The maximum face value of a unit is limited by the Bill to Rs.100. This, we hope, will make it possible for a large and growing number of persons to avail themselves of the facilities which the Trust is in a position to offer.
- (iv) As it is our intention that the Trust should cater to the needs of individual investors, including those whose savings or resources are not very considerable, we have considered it desirable to give them certain exemptions from the normal provisions of income-tax law. These exemptions will not be available to investors, who are not individuals, or to the individuals themselves, if their holdings of units are in excess of certain reasonable limits.
- (v) It has been represented by some people that we should follow the example of other countries and frame a general law on the lines of the legislation in force in those countries such as the Investment company Act of the USA or the Prevention of Fraud (Investment) Act of the United Kingdom, and thereby permit unit trust to be incorporated by the private people. We have rejected these suggestions and have embarked on the proposal to establish a statutory organization for this purpose because Government feel that this is the best method of achieving the objectives that we have in mind. It has to be recognized that the organizations in Western countries are larger and established and operate in much bigger and broad-based markets. They are governed by rules and regulations formulated by trade associations of these organizations themselves such as the Association of Unit Trusts in the United Kingdom and the National Securities Dealers' Association in the United States. In the conditions which now prevail in our country, when there may not be as much business for a number of competing organizations, and when it is also not clear that the operations of private unit trusts, if established, will not pass into the hands of managing agency houses and groups, I think, Government would be well advised in avoiding the risky and costly experiment of creating a number of weak organizations and in trying to exercise over them only such control as can be provided by any general law. Besides,

it would be almost impossible to provide to any private organization the tax concessions that have been incorporated in the measures that I have placed before you.

He expressed the hope that,

“...if an increasingly larger number of people are made conscious of the benefits of investment in these Trusts, we will be able to attract a sizable volume of funds for investment and also make the ownership of the units broad-based. I would christen the attempt as an adventure in small savings and I am confident that we are embarking on this adventure with every hope of its being successful.”

21.3 It will be instructive to benchmark the evolution of UTI against these specific points made at the time of its inception:

- (i) The negligence of the public sector institutional trustees, specifically IDBI, in running the organization, has already been highlighted in Chapter XIX.
- (ii) Regarding the stipulation of the unit holders being eligible for not less than 90 per cent of the income of the Trust in any given year, it definitely implied that if there was no income or a loss in a given year, there was no obligation on part of the UTI to distribute dividends. However, for four successive years since 1994-95, the UTI distributed dividends in excess of its income and in 1997-98 this wiped out the entire reserves of the scheme.
- (iii) The Deepak Parekh Committee has pointed out that the investor composition of US-64 has undergone several changes over the years. While the scheme initially focused on mobilizing the savings of small investors, it became a major destination of corporate funds during the 1980's. The Parekh Committee has pointed out that the increasing share of corporates in the schemes was partly driven by tax incentives available to them under Section 80M of the Income Tax Act besides the higher yields offered by US-64 compared to bank deposits and other comparable instruments. The Trust management appears to have actively targeted these corporate investors during this period and the problems US-64 has faced since 1992 can be traced to this change in composition of investors. The institutional investors were mostly short-term investors who used the scheme to park their short-term funds and avail tax benefits, thus leading to a lot of pressure on the liquidity of the scheme. The inversion of the investor profile is highlighted by the fact that the ratio of the share of individual to institutional investors in the outstanding unit capital of US-64 went down to 19:81 in 1991. The Parekh Committee has also observed that it was only consequent of the removal of US-64 from the ambit of tax benefits available under Section 80 M of the Income Tax Act that the relative proportion of corporate investors began to decline. Thus, the canons mentioned while setting up UTI were violated by actively wooing institutional investors and providing them tax benefits so that the scheme became dominated by institutional investors instead of individual ones.
- (iv) With the liberalization of the capital markets since 1992, the government allowed private mutual funds to enter the market. In order to provide a level playing field for all mutual funds, a UTI investor does not now enjoy any special tax benefits as compared to an investor in a private mutual fund. Though, the UTI still has a huge share of the assets under management by the mutual fund industry, this has come down from being above 80% in the 1990's to 57% in 2001.

This shows that through a change in its policies since the 1980's and negligent management, at least since the 1990's, the UTI violated the principles for which it was established. The entry

of private mutual funds since 1992 further marginalised the role of UTI as a unique institution under a separate Act of Parliament.

21.4 Another significant event in the legislative evolution of UTI was the amendment to the UTI Act with effect from 1986 which greatly expanded the scope of the business of UTI to allow it to become a lending institution which could discount and rediscount bills, grant loans and advances. The 'Statement of Objects and Reasons' in the Bill that introduced this amendment to the UTI Act stated as follows:

#### STATEMENT OF OBJECTS AND REASONS

The Unit Trust of India has been functioning for over two decades now. It has received the acceptance of the investors and has grown substantially in stature and strength. With its growth it has to better utilize the resources it mobilizes and generate income and profits through a variety of investment activities.

The principal objective of the Bill is to widen the scope of the business which the Trust can transact to enable the Trust to effectively channelise the funds mobilised by it from the public into more productive investment outlets both in India and outside India. This would provide for a good and growing return to the unit holder and the Trust would realize its objective by optimum utilization of opportunities for investment.

Apart from the above, the Bill also provides for management of investments by non-residents, merchant banking, direct lending, bills discounting, leasing and other matters, including a special provisions for enforcement of the claims of the Trust.

The Bill seeks to achieve the above objectives.

New Delhi;  
The 19th July 1985.

This change in the business of the UTI made it into a hybrid institution which could do term lending and as commented elsewhere attenuated the credit discipline in the organization.

#### **B. FUTURE OF UTI**

21.5 The Board of Trustees of UTI set up a 'Corporate Positioning' Committee under the Chairmanship of Sh. Y. H. Malegam. The terms of reference of the Committee were to review the competitive positioning of UTI in the light of among other things, globalisation and second-generation reforms in the Indian financial sector, emerging trends in mutual fund business and regulation and implications of any change in the UTI in the context of obligations of the UTI to existing unitholders under the UTI Act. It was also asked to recommend appropriate follow up action including legislative amendments to enable UTI to fulfill the Mutual Fund Regulations of SEBI and enhance its competitive position. The recommendations of the Malegam Committee, which submitted its report in October 2001, are given in **Appendix-XXXVIII**. The major recommendation of the Committee was that the structure of UTI should be changed to a three-tier one in line with the SEBI regulations to comprise a sponsor, a trustee company and an Asset Management Company (AMC). It also recommended that 60 per cent of the shareholding of the sponsoring company should be sold to a strategic partner while 40 per cent should vest with the institutions that hold the initial Rs 5 crore capital of UTI and have made an additional contribution of Rs. 445.5 crore pursuant to the Deepak Parekh Committee recommendations with the rider that none of these institutions should hold more than 25 per cent of the share capital. The trustee company should be a wholly owned subsidiary of the Sponsoring Company.

The shareholding of the sponsoring company in the AMC should not be more than 40 per cent with the balance offered to the public. The recommendation for a single AMC was based on the committee's belief that there would be a significant advantage of a single AMC owning the entire infrastructure and managing all the schemes of UTI. The Committee had suggested that a provision be made for the contingent liability arising out of the gap, if any, between the available assets in US-64 and guaranteed price to individual unitholders holdings upto 3000 units announced by the government in July 2001. It had also suggested a separate provision for the contingent liability arising as a result of the gap between the present value of the future liability under assured return schemes and the value of the assets available under the schemes. In order to implement these steps, the Malegam Committee recommended that the UTI Act should be repealed and replaced by a new enactment and the Government must be completely distanced from the Trust.

While restructuring of the UTI was not a specific term of reference of the Tarapore Committee, it felt that this issue had to be discussed if it was to meaningfully address its terms of reference. It recommended an amendment of the UTI Act to provide that wherever the UTI Act is in conflict with the SEBI Act, the SEBI Act will prevail. It recommended a formal separation of the asset management and trustee functions and the setting up of three AMC's for the US-64, income and growth schemes respectively. It also recommended that the UTI Bank could hold 49 percent of the capital of the three AMC's that would over time, enable greater private participation in the UTI.

The recommendations of the two Committees were broadly similar in asking for a restructuring and privatization of the UTI. The difference is in emphasis, with the Tarapore Committee recommending that privatization should not be immediate and that there should be three AMC's instead of one as proposed by the Malegam Committee. The Deepak Parekh Committee had also suggested a separate AMC for US-64 scheme.

21.6 Shri P. Chidambaram has commented on the fact that IDBI remained on the Board of Trustees of UTI despite starting its own mutual fund and stated that,

"It is a lesson to be learnt that the Government should not remain a mutual fund. If it does, it should quickly hive it off into the hands of other competent managers".

Dr. Manmohan Singh has also commented on the need to restructure UTI in his interaction with the Committee. He has stated,

"Let me say that the Unit Trust of India is now operating in a very different world than the world in which it was born. Today we have lot more competition in the mutual funds market and, therefore, if we tie down the Unit Trust of India in a manner in which it cannot compete with other entities, I do not think we will be serving the interests of those who invest their money in the Unit Trust of India. I feel it is necessary to relook at the role of the Unit Trust of India and I believe it is wise in a way to move to a new system in which the Unit Trust of India would have all the privileges and the obligations of a mutual fund. Given its strong portfolio, if it operates on its own, without undue interference from outside and the government, without looking over its shoulders all the time, I still believe and I have not given up hope that public sector entities in our country can compete effectively."

21.7 The government has taken significant decisions regarding the future funding of the US-64 and assured return schemes and the restructuring of UTI schemes. Through press releases

dated 31.8.2002 and 3.9.2002, the government made the following announcements regarding a UTI reform package and its earlier commitments regarding US-64:

- (i) Government would honour the redemption guarantee for US-64 unit holders. The liability in this account is currently estimated to be about Rs. 6000 crores which could vary depending upon the market conditions. In respect of the Assured Return Schemes (ARSS), wherever interest could be reset, it would be reset at a lower level. The current shortfall in these schemes is estimated to be about Rs. 8561 crores. Certain tax concessions on US-64 with a view to providing an incentive to unit holders to remain invested with the scheme were also being considered. The objective would also be to create a market and reduce redemptions.
- (ii) UTI would be divided into two parts:
  - (a) Old protected UTI (UTI-I) comprising of US-64 for which assured repurchase prices had been announced and assured return schemes; and
  - (b) New UTI (UTI-II) comprising of all net asset value based schemes.
- (iii) Government would meet its obligations annually to cover any deficit in UTI-I.
- (iv) UTI-I would be managed by Government appointed Administrator and a team of advisers nominated by Government.
- (v) UTI Act would be repealed through issue of an Ordinance and both UTI-I and UTI-II would be structured as per the SEBI Regulations. The Ministry was working on the ordinance for the repeal of the UTI Act.
- (vi) UTI-II would be managed by a professional Chairman and Board of Trustees and would be disinvested. Advertisements for appointment of professional managers for UTI-II will be issued after repeal of the UTI Act.
- (vii) The following tax concessions for UTI schemes were being contemplated:
  - (a) Any dividend received by the UTI-I from the corporates in which the assets of UTI-I are invested net of expenses, be passed on to the investors by the UTI and not retained to improve its NAV. This dividend would not be taxable in the hands of the investor; and
  - (b) Units of US-64 would be allowed to be traded in the market and exemption from capital gains tax would be available to those who sell the units. It was expected that those investors or fund managers who were willing to take a long-term view on the stocks of US-64 would find it attractive to take advantage of the exemption from capital gains tax.
- (viii) In view of the commitment of the Government of India to meet all shortfalls in UTI-I, UTI-I would not indulge in asset bleeding to meet redemption pressure and all sale and purchase of stocks would take place in UTI-I based upon the market perception of its fund managers or the management.
- (ix) Fresh units of US-64 in its present form would not be issued by UTI-I.
- (x) Operational aspects including, but not limited to distribution of assets and liabilities between UTI-I and UTI-II etc. would be worked out by the Ministry of Finance.
- (xi) The Ministry also wrote a letter to the Chairman, UTI on 24.8.2002 stating that equity holdings across schemes, which constituted significant portion of the controlling stake, should not be sold except through a strategic or private placement to earn highest

return. It was also clarified that there should not be distress sale of assets because of pressure of redemptions and that scrips across all schemes where UTI has the ability to disturb the management control of the companies concerned should be held for the time being and should not be sold in driblets. The letter stated that these could be sold in bulk at the appropriate time to get the best possible return.

Prior to the Government's Press releases regarding the future of UTI the Committee had interacted with Dr. E.A.S. Sarma who was Secretary, Economic Affairs from 22.7.1999 to 1.11.2001. His comment regarding the proposed changes was,

"As far as the latest bail-out is concerned, I went through the papers. I do not have any access to Government records but I have a few points for your consideration. The first thing is there is a split in UTI. It is now UTI-I and UTI-II. I feel that both these organizations are new entities. UTI, as a body, have almost about 180 listed companies. They own more than ten per cent equity in companies. When you sell this equity, UTI can use that leverage and get a good realization. Then, you take the case of ITC. In the case of ITC, when UTI sells this equity there is a certain amount of managing control and UTI can cash it. But then, by splitting it, you have got two organizations, two entities. You are actually reducing the leverage of UTI in selling those shares in many of these companies. So, you are actually weakening UTI indirectly. So, it is much better if UTI actually sells this equity, and then only you split it. It is a very important leverage that UTI has got."

Subsequently, the Government promulgated an Ordinance to Repeal the UTI Act of 1963 on 29/10/2002.

21.8 Asked for the reasons for the urgency, which necessitated the Government's recommendation for the promulgation of an Ordinance regarding UTI when this Committee was seized of all matters relating to the UTI, the current Finance Minister Shri Jaswant Singh has stated:

"...There is a question of the Government's involvement and commitment to certain aspects of the investments that people have made in the Unit Trust. To let the Unit Trust matter either fester or to continue to drift would not have been prudent, would not have been wise; urgent action was necessary. The Cabinet considered the recommendations of the Finance Ministry and accepted that this matter needed to be acted with dispatch."

When it was pointed out that the Government, in the best spirit of parliamentary constitutionalism, could have awaited this Committee's report which was at the stage of finalisation, he stated that:

"...The Government has a continuing responsibility as the Executive. We are fully mindful of the recommendations of the Parliament as well of the recommendations of the Joint Parliamentary Committee. Whenever the Parliament finally decides upon what recommendations of the JPC are to be implemented, the Ordinance that has been issued on the question of Unit Trust could not have been delayed for the reasons that I have already explained, in the Ordinance such amendments, additions, improvements, deletions, as the Parliament wants it to be done, in its wisdom, shall of course have to be done. The Ordinance has to come to the Parliament for approval and then it has to be converted into a Bill. Therefore, no disrespect is meant either to the institution of Parliament or to the JPC or to the functioning of the JPC. We have to continue, as the Executive, to take decisions. If we do not take decisions, then we will continue to be stymied."

It was pointed out that the governments plan is to split the UTI into two parts and privatise one part. Asked how the Government would be able to reverse its decision at a later date if this Committee, in its wisdom, arrived at a different conclusion Shri Jaswant Singh replied:

“First, the recommendation talks of the Unit-II. There are two parts. Unit-II is to adopt the route of privatization and improve the management straightway. Privatisation has been suggested five years down the line. The division in assets is yet to take place. It is because assets in Unit-II are also not Government assets. They are public assets. They will have to be managed. If Parliament says that this is not to be privatized even at the cost of de-valuation of those assets, then they will not be privatized. Moreover, privatization is only five years down the line. It is not tomorrow that it is going to happen.”

Subsequently, it was learnt through press reports that UTI-II has been registered as UTI AMC Ltd. in which the Life Insurance Corporation (LIC), the State Bank of India, the Punjab National Bank and the Bank of Baroda have picked up a 25% stake each. Also, the Unit Trust of India (Transfer of Undertaking and Repeal) Bill, 2002 was passed in Lok Sabha on 28.11.2002 and the Rajya Sabha on 3.12.2002.

**21.9 The Committee would like to put on record the following observations and recommendations:**

- (i) The financial institutions that have been chosen to sponsor UTI-II have in the past sponsored their own mutual funds. Also, both LIC and SBI previously had their nominees on the Board of Trustees of UTI and the Committee have elsewhere commented on the conflict of interest and the need for these institutions to separate themselves from UTI. The Committee therefore recommend that the institutions chosen to sponsor UTI should be those that have not sponsored their own mutual funds. In case this is not found feasible, the Government must spell out in detail both through legislation and through policy guidelines as to how it proposes to insulate UTI-II from the inherent conflict of interest as regards these institutions.
- (ii) There are a number of civil, criminal, departmental and vigilance proceedings pending in UTI with regard to the irregularities in its investment decisions. The Committee have also recommended certain actions to enforce accountability for previous misdemeanors. The Committee recommend that legislation regarding UTI as well as Government policy should take these proceedings into account so that they are concluded expeditiously and are not hampered by the fact that the UTI Act of 1963 has been repealed.
- (iii) The Government has stated that a Government appointed administrator and a team of advisors nominated by the Government will manage UTI-I. It needs to be pointed out that even in the case of the assured return schemes and US-64 which are under the purview of UTI-I, day to day decisions have to be taken regarding buying, holding and selling of stocks. This is not an activity which can be conducted by Government officials because the procedures and processes in Government do not allow quick commercial decisions. The Committee therefore recommend that the schemes in UTI-I should also be managed by independent fund managers preferably from UTI-II through a fee based relationship. The management fee can be worked out keeping in mind that the Government has already provided a huge bail out to UTI.
- (iv) UTI can derive optimum value for equity holdings across schemes that constitute significant portion of the controlling stake of a company by selling them through strategic or private placement. The Committee recommend that a suitable system be devised so that such equity holdings of UTI-I and UTI-II are divested together so that maximum benefit can accrue to the investors in these funds.

- (v) Government has stated that a professional Chairman and Board of Trustees will manage UTI-II and that advertisements for appointment of professional managers will be issued. The Committee recommend that it should be ensured that the selection of the Chairman and professional managers of UTI-II should be done in a transparent manner, whether they are picked up from the public or private sector. If an official from the public sector is selected, in no case should deputation from the parent organisation be allowed and the person chosen should be asked to sever all connections with the previous employer. This is imperative because under no circumstance should there be a public perception that the mutual fund schemes of UTI-II are subject to guarantee by the Government and will be bailed out in case of losses.

NEW DELHI;  
*December 12, 2002*  
*Agrahayana 21, 1924 (Saka)*

SRI PRAKASH MANI TRIPATHI,  
*Chairman,*  
*Joint Committee on Stock Market Scam*  
*and Matters Relating Thereto.*

## OBSERVATIONS/CONCLUSIONS/RECOMMENDATIONS

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Sl.No.	Para No.	Observations/Conclusions/Recommendations
1	2	3

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### PART I

#### OVERVIEW

1. 2.7 In the present enquiry 'Scam' has to be considered predominantly in the context of the Stock/Capital market. Individual cases of financial fraud in themselves may not constitute a scam. But persistent and pervasive misappropriation of public funds falling under the purview of statutory regulators and involving issues of governance becomes a scam.
2. 2.8 The period of the scam, the main players involved, and its intensity have been examined by the Committee. The present scam includes the role of banks, stock exchanges, brokers, the Unit Trust of India (UTI), corporate bodies and chartered accountants. Regulatory authorities like SEBI, RBI and the Department of Company Affairs (DCA) should have been able to lay down and implement guidelines and procedures that could prevent such a scam or at least activate red alerts that could lead to early detection, investigation and action against fraud as well as the rectification of any systemic deficiencies discovered. Equally, supervisory authorities and coordinating bodies, such as the Ministry of Finance and HLCC, should have been more pro-active and vigilant in recognizing that liberalization requires strong and effective regulation and greater autonomy for regulators must go hand-in-hand with the accountability of regulators to the country through the Ministry of Finance which, in our scheme of constitutional jurisprudence, is responsible to Parliament for the financial health of the economy, including sectors regulated by statutory and other regulators. Moreover, the Ministry of Finance, the Regulators and all others concerned had the benefit of the voluminous and detailed Action Taken Reports (ATRs) submitted by Government to Parliament on the numerous recommendations of the 1993 Report of the Joint Committee on irregularities in securities and banking transactions. Concerted mutual interaction between Government and the Regulators, especially through the institutional mechanism of HLCC, could have signally contributed to effective pre-emptive and corrective action to forestall or moderate the scam by the early detection of wrong-doing.
3. 2.11 Wrong doing by banks have also contributed significantly towards the scam although the number of banks involved in committing irregularities

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- in comparison to the total number of banks functioning in our country is small. Notably, major banks were nationalized in 1969 but pursuant to economic liberalization, new private banks including foreign banks were allowed into banking sector. Public sector banks were in general not involved in the scam and have fared well but private sector banks need to be closely watched, especially in the area of risk management and stricter regulation. Cooperative banks have tended to ignore rules, procedures and risk management. This should set the RBI and the Government thinking. There is need to have more effective regulation in the banking sector as a whole with particular emphasis on cooperative banks.
4. 2.12 One of the major concerns of the Committee was to look at the trading practices and procedures adopted in the stock market. Stock Exchanges, brokers and regulators play a very important role in determining the transparency of procedures and practices in the stock markets. The Committee went into the functioning of these entities and generally found that the quality of governance and the practices followed in the stock exchanges were different from exchange to exchange, having evolved from different local economic, social and historical conditions. SEBI, as a regulator, had made some attempts at standardizing the practices in these exchanges and had also instituted arrangements whereby the happening in the stock exchanges would come to its notice. But, in practice, the system did not function efficiently or in a transparent manner. When stock markets were rising, there was general lack of concern to see that such a rise should be in consonance with the integrity of the market and not the consequence of manipulation or other malpractice. On the other hand, when the markets went into a steep fall, there was concern all over. Such dissonance in the approach to issues of regulation and good governance needs to be replaced with effective regulation which concentrates on market integrity and investor protection whether at any given point of time the market is buoyant or not. This Committee did not concern itself with either the rise or fall of the market but specifically with manipulations or irregularities that caused unusual rise and fall.
5. 2.13 The procedures, adherence to rules and the concern for common investor appear to have been quite loose in the CSE. The payment problem that surfaced in Calcutta Stock Exchange brought to light many ills of the institution. Worse, those ills such as unofficial badla could have been recognised and corrected well in time.
6. 2.15 The Committee note that Ketan Parekh who emerged as a key player in this scam received large sums of money from the banks as well as from the Corporate bodies during the period when SENSEX was falling rapidly. This led the Committee to believe that there was a nexus between Ketan Parekh, banks and the corporate houses. The Committee recommend that this nexus be further investigated by SEBI or Deptt. of Company Affairs expeditiously.
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7. 2.16 The process of liberalization of the economy has continued apace and it is market forces that will increasingly determine economic trends in the country. With liberalization, the role of the Government as a direct player in the financial market will diminish. This makes it all the more necessary that the procedures and guidelines laid down for the creation and perpetuation of fair and transparent financial markets and institutions like stock exchanges and banks have to be more specific, and effective mechanisms have to be put in place to ensure that they are regularly followed. That job will have to be done by the regulatory authorities; viz., SEBI, RBI and DCA in liaison with investigative agencies like the Income Tax Department, Enforcement Directorate and the Central Bureau of Investigation. Coordination with Government on policy issues will, however, continue to be central to good governance as there can be no escaping Government's responsibility to Parliament and the country. Therefore, Government must recognize that transactions in the market will be insulated from scams only if the relinquishment of Government control over the economy is accompanied by strong and effective regulatory bodies. This point had also been underlined by the earlier JPC Report, 1993 on Irregularities in Securities and Banking Transactions.
8. 2.17 The proceedings before the Committee themselves acted as a catalyst for many reforms in the system, which were put in place during the Committee's pendency. These actions by regulators like SEBI and RBI and by the Ministry of Finance have been touched upon in various chapters. The Committee feel that after the presentation to Parliament in August and December 1994 of the Action Taken Reports (ATRs) on the scam relating to irregularities in securities and banking transactions, the will to implement various suggestions of the previous Committee petered out. But, as soon as this Committee began its sittings and searching questions were asked, SEBI, RBI and other regulatory authorities including Ministry of Finance, went into active mode. Had this state of affairs prevailed after the Action Taken Report, the probability of the present Scam would have been negligible.
9. 2.20 This Scam is basically the manipulation of the capital market to benefit market operators, brokers, corporate entities and their promoters and managements. Certain banks, notably private and co-operative banks, stock exchanges, overseas corporate bodies and financial institutions were willing facilitators in this exercise. The scam lies not in the rise and fall of prices in the stock market, but in large scale manipulations like the diversion of funds, fraudulent use of banks funds, use of public funds by institutions like the Unit Trust of India (UTI), violation of risk norms on the stock exchanges and banks, and use of funds coming through overseas corporate bodies to transfer stock holdings and stock market profits out of the country. These activities went largely unnoticed. While the stock market was rising, there was inadequate attempt to ensure that this was not due to manipulations and malpractices. In contrast,
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during the precipitous fall in March 2001 the regulators showed greater concern. Another aspect of concern has been the emergence of a practice of non-accountability in our financial system. The effectiveness of regulations and their implementation, the role of the regulatory bodies and the continuing decline in the banking systems have been critically examined, for which the regulators, financial institutions, banks, Registrars of Co-operative Societies, perhaps corporate entities and their promoters and managements, brokers, auditors and stock exchanges are responsible in varying degrees. The parameters of governmental responsibility have also been taken into account.

10. 2.21 It is the considered view of the Committee that besides the factors detailed in the previous paragraph, the lack of progress in implementing the recommendations of the last Joint Parliamentary Committee set up in 1992 to enquire into Irregularities in Securities and Banking Transactions emboldened wrong-doers and unscrupulous elements to indulge in financial misconduct. The Special Cell constituted by the Ministry of Finance in June 1994 to investigate the nexus between brokers and industrial houses in pursuance of the recommendation of the previous Committee having gone defunct since 22 May 1995, without coming out with any tangible findings or recommendations for remedial action, is one of the examples of apathy on the part of different agencies and departments concerned. The Committee express their concern at the way the supervisory authorities have been performing their role and the regulators have been exercising their regulatory responsibilities. That the regulatory bodies failed in exercising prudent supervision on the activities of the stock market and banking transactions, became evident during the course of evidence taken by the Committee and this has been detailed in the succeeding chapters. In the Committee's view no financial system can work efficiently even if innumerable regulations are put in place, unless there is a system of accountability, cohesion and close cooperation in the working of different agencies of the government and the regulators.
11. 2.22 In August 2001, after the freeze by UTI in US-64 unit repurchases, the Committee were additionally mandated by Parliament to enquire into UTI matters. The Committee find that weaknesses in management and regulations of stock exchanges was compounded by serious management deficiencies in the UTI and financial institutions. The Committee also examined the interaction between the Ministry of Finance and UTI in the context of the responsibilities of government arising out of the UTI Act of 1963 in particular of US-64 involving the investments of several million unit holders. These issues are dealt with in detail in Part II of this Report.

#### IMPLEMENTATION

12. 3.4 The overall impression that the JPC gathered was that after a certain time there was slackness in the implementation of the ATRs. Consequently,

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the Committee's general impression is that parliamentary committees carry out their work and make their recommendations but, at the implementation stage, things are put under the carpet. This impression prevails in the financial world but more so in the mind of the public in general. There being no fear that swift and effective action will be forthcoming, the players in the financial world ignore the laid down rules, regulations and procedures without any fear of punishment.

13. 3.6 Specific issues where the implementation was found inadequate are contained in subsequent paragraphs.
14. 3.10 Unless the regulators are alert and the punishment is swift and adequately deterrent, scamsters will continue to indulge in financial misconduct. Under the present system, there is no deterrence to malpractices, irregularities and manipulations in capital markets.
15. 3.11 Lack of urgency on the part of the Government has led to a stage where after more than 9 years, 66 out of 72 cases of 1992 scam have yet to be adjudicated. This clearly sends out a signal that future wrong doers can evade the consequences of their wrongs and can also enjoy their ill-gotten gains. The Committee emphasise that adequate number of courts should be set up to ensure final disposal of cases within two years.
16. 3.14 The Committee regret to note that the Special Cell constituted by CBDT on the recommendation of the previous JPC in order to examine the role of Industrial Houses with regard to the Securities Scam 1992 became non-functional without arriving at any findings after holding 5 meetings in 1994 and 1995. The Special Cell was reactivated after the present JPC commenced functioning. The Cell has now arrived at the finding that nexus between brokers and banks/financial institutions was prominently visible more with Foreign Banks through various Instruments. The nexus between Industrial/Business Houses and the Banks was mainly through the Portfolio Management Scheme in violation of RBI guidelines, etc. The Committee hope that in the light of these findings necessary action will be taken.
17. 3.18 The Department of Company Affairs exercises supervision over the affairs of Institute of Chartered Accountants of India and 6 members nominated by the Central Government are on the Council which manages the affairs of the Institute. The delay in adjudicating 23 out of 27 disciplinary proceedings and the approval of the names of 3 firms to conduct audit of banks even though the disciplinary proceedings are pending in their case shows complete lack of urgency and disregard of the promises on the JPC's recommendations by the Institute of Chartered Accountants of India (ICAI), the government as well as the RBI. This Committee have also come across failures on the part of certain auditors in the present scam. Auditors have a greater responsibility and if they themselves become a part of malaise, the financial checks and balances would collapse. Department of Company Affairs should ensure expeditious disposal of disciplinary proceedings.
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18.	3.19	It is obvious to the Committee that implementation was far from satisfactory.
19.	3.21	Dual control (that of RBI and the Registrar of Cooperative society of the State) is a matter of serious concern. RBI should have followed it up with financial penalty or such like punishment.
20.	3.22	These instances of regulatory laxity in the present scam are a result of delay by the RBI in following up its own inspection and observations on the functioning of banks' operations. It was also noticed by the Committee that RBI seemed content with the routine replies of the banks concerned. There appears to have been a lack of concern and absence of strict action till matters went out of hand.
21.	3.24	It has been observed by this JPC that there was a very low level of attendance of SEBI nominated Directors (including nominated Directors who were employees of SEBI) in the board meetings of Calcutta Stock Exchange (where a pay in default occurred in March 2001 primarily due to lack of proper margin collection). One Director did not attend even a single meeting out of 26; another attended 3 out of 13 and yet another 25 out of 62.
22.	3.25	The purpose of having independent nominated Directors mentioned in the ATR was, therefore, lost as the elected broker Directors attended all Board meetings and in effect took all the decisions. Thus, the implementation in respect of close supervision of the working of the Stock Exchanges by SEBI was in fact not effective.
23.	3.29	Regular inspection and follow up action of Stock Exchanges was obviously not implemented properly by SEBI. The CSE and erring brokers were let off the hook as early as 1994 which resulted in the payment crisis on CSE in March 2001. Both CSE and SEBI were lax in monitoring, surveillance, investigation and implementation. SEBI's action was totally inadequate in dealing with irregularities mentioned in paras 3.26 and 3.27. Had the action been prompt, many of the CSE's shortcomings could have been corrected in time.
24.	3.30	The instances of lack of implementation indicated above are illustrative. But this Committee's main concern is that a thorough inquiry can become meaningless unless concrete steps emerge from such an inquiry, and that their recommendations, as accepted by the Government, are implemented effectively to their logical conclusion. This is borne out of our experience from the report of JPC 1992, and the two ATRs.
25.	3.31	Accordingly, this Committee feel that fresh thinking has to go into the implementation aspect. The Committee recommend following steps to effectively implement the recommendations contained in this report :  (a) The Government should present their ATR on this report within 6 months of the presentation of the report.

- (b) The High Level Co-ordination Committee (HLCC) functioning in the Ministry of Finance in addition to its existing function, should be entrusted with the task of ensuring expeditious implementation of the recommendations of the JPC. For this purpose, there should be a separate Secretariat in the Ministry of Finance to assist HLCC for its efficient and effective functioning.
- (c) Every six months, the government should present to Parliament a report of progress on ATRs on the recommendations of JPCs until action on all the recommendations has been fully implemented to the satisfaction of Parliament.
26. 3.32 The Committee are concerned to learn that the Ministry of Finance took so casual an approach to the implementation of JPC, 1992 recommendations, as set out in the two ATRs of 1994, that they neither monitored implementation nor informed successive Finance Ministers about non-implementation. This culture must change.
27. 3.33 At Appendix-III is given a chart which sets out how many recommendations contained in this Report are analogous to the recommendations of the earlier JPC, starkly revealing the extent of non-implementation which characterises the system.

#### IRREGULARITIES BY BROKERS INCLUDING SHCIL

28. 4.4 This does not reflect well on the alertness of the Regulator to happenings in the market.
29. 4.42 The Committee find that Shri Ketan Parekh was a key person involved in all dimensions of the stock market scam which surfaced in March 2001, as also in payments problem in the Calcutta Stock Exchange (CSE) and the crash of Madhavpura Mercantile Cooperative Bank (MMCB). He was operating through a large number of entities which facilitated hiding the nexus between source of funds flow and their ultimate use. Various layers were created in his transactions so that it became difficult to link the source of fund with the actual user of fund. SEBI's investigations after the scam have revealed that the amount outstanding from Ketan Parekh entities to certain corporate houses at the end of April, 2001 was over Rs. 1,273 crore. Dues to Ketan Parekh entities to MNCB were around Rs. 888 crore and to Global Trust Bank over Rs. 266 crore. There were also dues to other entities. The funds received from corporate houses and banks have gone to three major broker groups in CSE and been utilized in capital market operations. Ketan Parekh entities appear to have chosen CSE mainly to exploit the known weaknesses of the Exchange. They also used a networking of various Overseas Corporate Bodies, Foreign Institutional Investor sub-accounts and mutual funds for large transactions. Not till the MNCB crash occurred did the regulatory authorities even begin looking in Shri Ketan Parekh's directions although this was being underlined in Parliament

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- and the media. It is difficult to believe that the Stock Exchanges or SEBI were quite unaware of what was going on in the market when Ketan Parekh entities were manipulating the market using their network. Nor did the High Level Coordination Committee (HLCC) or the SEBI seek a check on where Shri Ketan Parekh was getting his funds from or his methods of manipulating the market. This is all the more disturbing in the context of the previous JPC's findings against Shri Ketan Parekh.
30. 4.43 During the oral evidence before the Committee, Shri Ketan Parekh owned up involvement of his entities in the CSE payment crisis and the crash of Madhavpura Mercantile Co-operative Bank in March, 2001. Shri Ketan Parekh admitted that his entities did build huge positions in the market in select scrips, that they grossly over committed themselves to the market and that they crossed the principles of risk management. Further, he also conceded that certain trades such as the sale to Credit Suisse First Boston and Dresdner Kleinwort Benson, which SEBI described as 'Circular trades', were pre-arranged trades though he claimed that those trades were meant for short term funds. While acknowledging that his entities received funds from certain corporate houses and that they built huge positions in the market in these companies, Shri Ketan Parekh asserted that his entities received those moneys only after the start of the market fall from September, 2000 and that the corporate funds were not for investment in their own shares nor for jacking up price. Notably, he disclosed that MNCB issued pay orders without balance in his account. Shri Ketan Parekh also divulged that his entities paid to Calcutta based brokers a sum of Rs. 3,191 crore towards purchase of shares, payment of margin, etc. and acknowledged that they availed of the advantage of faulty margin system in Calcutta Stock Exchange. All these admissions of Shri Ketan Parekh corroborate the SEBI's findings. The committee note that SEBI has since taken action to cancel the registration of Triumph International Finance (India) Limited. The Committee urge that SEBI must complete its remaining investigation expeditiously and take swift action for various violations by Ketan Parekh entities including the criminal action which is stated to be under contemplation.
31. 4.44 The various acts of omission and commission having been clearly established, the Committee urge that the Government should take all necessary steps to finalize proceedings against Ketan Parekh entities and to ensure that suitable action is taken against them without delay. The Committee also urge that expeditious action should be taken to ascertain the facts regarding the Swiss bank account of Shri Ketan Parekh and to follow up the matter.
32. 4.45 Ketan Parekh entities owe considerable sum of money to Banks. Expeditious action should be taken to recover this amount from Ketan Parekh entities.
33. 4.68 The Committee note that the three broking groups belonging to Shri D.K. Singhania, Shri A.K. Poddar and Shri H.C. Biyani were primarily
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responsible for the payment problem in March 2001 in CSE. Their default in pay-in obligations in three settlements in March 2001 was about Rs. 107 crore. D.K. Singhanian Group and A.K. Poddar Group along with Sanjay Khemani Group received over a period a sum of Rs. 3191 crore from Ketan Parekh entities for taking deliveries on behalf of the latter and had close linkages with Shri Ketan Parekh. The Committee find that these broker groups exploited the weaknesses in the working of Calcutta Stock Exchange as discussed in another section of this Report and built large concentrated position in a few scrips in violation of exposure limits. The brokers' plea of ignorance about the defects in the CSE margin system is not convincing. The Committee urge that the civil and criminal proceedings initiated against the defaulted brokers should be expeditiously completed and the guilty punished at the earliest.

34. 4.69 Shri H.C. Biyani had deposited 10 lakh shares of DSQ Software Ltd. as security towards his pay-in dues to CSE on 21.3.2001. It transpired during the Committee's examination that Shri Biyani did not have ownership of those shares when he deposited them and could not have transferred the shares to CSE. It was a fraud on CSE by Shri Biyani. CSE has reportedly filed an FIR against Shri Biyani and Biyani Securities in this regard. The Committee expect that the matter be investigated and on the basis of outcome thereof, appropriate criminal proceedings will be initiated.
35. 4.70 In another instance, Shri H.C. Biyani had entered into a transaction with Stock Holding Corp. of India Ltd. (SHCIL) which was classified by CSE as trade in the nature of accommodation and expunged the same. The trade in question related to his sale of DSQ Industries shares under Sell-n-Cash scheme of SHCIL on 2.3.2001 for Rs.24.45 crore where the counterparty broker was Shri Biyani himself. This matter has since been looked into by an independent inquiry appointed by SHCIL as discussed in the section on SHCIL.
36. 4.117 SEBI has not so far provided conclusive evidence to substantiate its conclusions in regard to the brokers/groups mentioned in Section 3 above. Accordingly, the Committee recommend further investigations in this regard.
37. 4.131 The Committee note that SEBI inspection has brought out various irregularities by Stock Holding Corporation of India Ltd. (SHCIL) in respect of its transactions under 'Sell-N-Cash'/'Cash-on-Payout' schemes with Biyani Group of Calcutta Stock Exchange. Some of the irregularities are :—
- Exposure of one-third of its net worth (exposure of about Rs. 43 crore) for one scrip and one broker group viz., Biyani Group;
  - Doing trade of 7.2 lakh shares when there were only 1.1 lakh shares in the beneficiary account;

- Negotiating with promoter Director of the traded scrip for extension of a facility to a broker;
- Issue of a letter of comfort/assurance to IndusInd Bank by local office followed by Head Office regarding issuance of cheques;
- Issue of cheques by unauthorized signatories;
- Reduction of service charge from 0.5% to 0.2%.

The Committee hope that SEBI will take suitable action on the basis of its above findings.

38. 4.132 SHCIL at the instance of JPC instituted an independent enquiry to look into this case. The enquiry was conducted by a Chartered Accountant (Haribhakti & Co.). The enquiry has concluded that though the Sell-N-Cash scheme was not meant for brokers, SHCIL extended the facility to brokers and that the procedures laid down were not followed. The limits laid down were exceeded and such excesses were ratified by the then Managing Director and C.E.O. The enquiry has concluded that while they have not come across any evidence to indicate malafide intention on the part of officials of SHCIL, there was negligence in operation of the schemes and lack of proper judgement on the part of the Managing Director and C.E.O. in approving the transaction and not keeping the Board informed in advance. The enquiry report has recommended certain corrective measures such as review of the Sell-N-Cash and Cash-on-payout Schemes, restricting the schemes only to investors, etc. The Committee urge that necessary action be taken on the measures suggested by the enquiry.
39. 4.133 SEBI's report has highlighted that SHCIL did not follow prudential norms and regulations while conducting its business. The 'Sell-N-Cash' Scheme envisaged for small investors has been used by SHCIL as an avenue for financing brokers and used as a funding mechanism for creating artificial market in scrips. There was also lack of internal control procedures. The Committee urge SHCIL to look into these issues and devise appropriate norms to ensure that its schemes/activities do not result in market manipulation or promote unfair trade practices.

#### BANKS

40. 5.54 The Committee note that although there do not appear to have been any serious violations by the Bank of the guidelines issued by RBI till 30.6.2000, there was thereafter a steep increase in advances without a corresponding increase in deposits. In fact, the CD ratio went up between October 2000 and March 2001 from 76 per cent to 131 per cent, which meant that the Bank was lending beyond its means. The steep increase in advances was mainly owing to the Bank improperly and illegitimately making vast sums available, under various guises, to

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certain stockbrokers, in particular entities controlled by Shri Ketan Parekh. That the exponential increase of advances to KP Group companies occurred when the market was falling shows that the nexus between the Bank and the broker was of long-standing. The Committee also note that at the Mandvi branch, Mumbai of the Bank, large Pay Orders were issued to the Ketan Parekh group of companies aggregating Rs. 4626.19 crore between 27.11.2000 and 9.3.2001. Of the advances outstanding at Rs 1594.17 crore (as on 16.3.2001) a sum of Rs. 1082.22 crore, constituting 68% of the advances, were in the nature of unsecured advances granted to 21 borrowal accounts belonging to stock brokers. Out of these, at least 10 accounts indicated linkages with Ketan Parekh, in whose case the exposure was Rs 943.57 crore i.e. 77.9% of total advances to share brokers.

41. 5.55 MNCB was relying on the Call Money Market to meet with exigencies but on no occasions defaulted in its repayment obligations except on 7.3.2001 when its borrowings from Call Money market, attributed largely to the advances it had given to the Ketan Parekh and other broking entities in the form of Pay-Orders etc. were left unsecured. While the Ketan Parekh entities were able to avail of instant credit by discounting the MNCB Pay-Orders aggregating to Rs.137 crore from the Stock Exchange Branch of Bank of India, Mumbai, the entities enjoyed substantial sanctioned limits, MNCB failed to meet with its obligations at the Brihan Mumbai Clearing House when the said Pay-Orders were presented for settlement on 9/3/2001. The feasibility of the Bank's harnessing potential alternative means to satisfy its clearance obligations was nipped in the bud when RBI stepped in on 13.3.2001 and invoked Rule 11 barring MNCB from accessing the Clearing House in any manner with retrospective effect from 9.3.2001. The Committee are of the view that while the nexus between Chairman, MNCB and Chairman of KP group companies warrants further investigation by the agencies concerned, it is also necessary for RBI and SEBI to draw the right lessons from the regulatory point-of-view to put in place an integrated system of alerts which would piece together disparate signals from different elements of the market to generate special attention to any unusual activity anywhere in the system which might have a bearing on the integrity of the stock market.
42. 5.56 The Committee take serious note that the Chairman and top executives of the Madhavpura Mercantile Co-operative Bank indulged in a series of irregularities flouting all prudent Banking norms and the guidelines laid down by the Reserve Bank of India. This resulted in a run on the Bank in March 2001 and triggered a run on the deposits of several co-operative Banks, not only in Ahmedabad but also in other towns of Gujarat. In view of its inability to meet the heavy demand of the depositors, MNCB closed down all its branches on 13.3.2001.

43. 5.57 Other glaring irregularities pointed out by RBI in their special scrutiny undertaken after the exposure of the scam in March 2001 were that, in several cases, the balances outstanding in the borrowal accounts were far beyond sanctioned limits, the gap ranging between 100% and 400%. The wide deviation between sanctioned limits and outstandings reflected overdrawals which were allowed as per the oral instructions of the Chairman and these were not confirmed even subsequently. Loans to stockbroking companies were unsecured and much beyond permissible limits. The purpose for which such advances were given was indicated as "Loans against Fixed Assets" primarily with a view to camouflaging the Bank's lending to brokers in violation of RBI guidelines. Moreover, the Bank's Board violated RBI guidelines relating to the review of large borrowal accounts. Limits were sanctioned without proper credit appraisal and post-disbursement supervision was ineffective. Besides, the Bank had been resorting to large borrowings through the call money market for the purpose of lending to these big borrowal accounts. Between December 2000 and March 2001, the Bank's daily exposure to the Call Money Markets rose from Rs. 122 crore to a peak of Rs. 270 crore and stood at Rs. 197 crore on 21.3.2001.
44. 5.58 During the RBI inspection conducted for the year 1999, it has been noticed that the standard of credit appraisal obtaining in the Bank was deficient. However, RBI did not take corrective action. The Bank violated RBI directives with respect to credit exposure, sanctioning credit limits much in excess of its credit exposure ceiling. It also defaulted in the maintenance of the Statutory Liquidity Ratio (SLR). Although RBI has said CD ratios were not required to be included in monthly/quarterly reports received from UCBs, the Committee are of the view that even in the absence of a specific provision for the calculation of CD ratios in the format of report submitted to RBI, discrepancies between credits and deposits in MNCB returns should have been evident from the face of the record.
45. 5.59 The Committee take serious note of the fact that the then Chairman of the Bank was instrumental in getting huge amounts of loans sanctioned by the Bank in blatant violation of extant rules/guidelines either for his personal gain or for the benefit of his close relations. He misused his official position for his personal business interests by securing from the Bank credit facilities much beyond exposure norms for M/s Madhur Food Products Ltd., a company in which he was a Director. Large funds were transferred between different accounts belonging to the business concerns of the Chairman; for instance, amounts were withdrawn from the loan account of M/s Madhur Food Products and transferred to other accounts of the Chairman, that is, M/s Madhur Shares and Stocks Ltd. and M/s Madhur Capital and Finance Ltd. In the pursuit of his vested interests, the Chairman colluded with Ketan Parekh. For example, between 17.1.2001 and 28.2.2001, Rs. 135 crore were transferred from the hypothecation account of M/s Panther FinCap and Management Services Pvt Ltd.—a company belonging to the Ketan Parekh Group to

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- the current account of M/s Madhur Capital and Finance Pvt Ltd.—a company belonging to the Bank Chairman’s group. This appears to have been done in consideration of unduly large credits extended by the Bank to the Ketan Parekh Group at its Mandvi branch, Mumbai, indicating a business nexus between the Chairman and Shri Ketan Parekh.
46. 5.60 The Committee note that way back in 1998, one Shri Jasubhai S. Patel of Ahmedabad registered a complaint against MMCB regarding misuse of public monies and gross violation of rules/regulations etc., simultaneously but separately with the Registrar of Cooperative Societies, Gujarat and RBI. RCS Gujarat conducted an inquiry through the District Registrar, Ahmedabad who gave MMCB a clean chit. However, after conducting its own investigation, RBI found that the Chairman of the Bank was indulging in all sorts of malpractices for personal gains. RBI also noted many other irregularities. Yet, although the RBI report was forwarded to RCS Gujarat for taking further action, RCS Gujarat merely reiterated the clean chit given earlier by the District Registrar. Thereafter, RBI did not pursue the matter further. Nor did RBI take up the matter, as it should have, with the Central Registrar of Co-operatives. The Committee are unable to accept the plea taken by RBI that they were helpless in the matter in view of the report received from the State Registrar.
47. 5.61 The Committee question the role played by the State Registrar, who, instead of constituting a special audit, just forwarded the report received from the District Registrar and did not bother himself to investigate the veracity of the charges made. The Committee consider this a serious lapse on the part of the State Registrar. The Committee find that under the Act itself, the State Registrar was vested with wide powers and could have superseded the board. Consequent to the delegation of authority by the Central Registrar to the State Registrar, there should have been a mechanism in place for the Central Registrar to be informed of any unusual activity in the Bank.
48. 5.62 The question of duality of control engaged the consideration of the Committee. This aspect is covered in detail under the chapter relating to RBI.
49. 5.63 The Committee also note the dubious role played by the auditors who failed to point out serious irregularities while conducting audit for the year 1998-99 and 1999-2000. A formal complaint is reported to have been lodged in this regard by the RCS Gujarat with the Institute of Chartered Accountants of India in March, 2002. Even in the absence of the calculation of the CD ratio, discrepancy between credit to deposit were evident from the face of the records.
50. 5.64 The Committee were informed that a criminal complaint was lodged by the RBI in the court of Chief Metropolitan Magistrate, Ahmedabad against the MMCB, its Chairman and Managing Director on 14.3.2001
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under section 46 of the Banking Regulation Act 1949, read with section 58(B) of the Reserve Bank of India Act, 1934, for having made false statements to RBI with respect to call money borrowing and also failing to meet its assurance for submitting the required information. A criminal complaint had also been lodged by the Administrator of MMCB Ltd. with Madhavpura Police Station, Ahmedabad on 21.4.2001. Later, in terms of the order of the High Court of Gujarat, Ahmedabad dated 2.5.2001, CBI has been directed to investigate the deeds/misdeeds of the ex-Chairman and Managing Director and other officials involved in the mismanagement of the Bank. In pursuance of court orders, the case was transferred to CBI, Mumbai, and an FIR has been registered with Special Police Establishment, Mumbai Branch on 18.5.2001. On 1.6.2001, charge sheet in the case has been filed against Ketan.V.Parekh, Kartik.K. Parekh, Ramesh Parekh, Chairman, MMCB, Devendra B. Pandya, Managing Director, MMCB and Jagdish.B.Pandya, Branch Manager u/s 120-B,420,467,468 and 471 of IPC. The case is stated to be pending in the Court of the Chief Metropolitan Magistrate, Mumbai. The Committee desire that these cases be decided expeditiously.

51. 5.65

The Committee note that in view of the serious irregularities committed by MMCB, a series of measures have been taken by RBI whereby UCBs have been prohibited from extending financial assistance against securities of shares and debentures. RBI has also prohibited UCBs from grant of advances from financing Initial Public Offerings (IPOs). RBI has also directed that steps be taken to recall all such advances to stock brokers. Whereas prior to 11.6.2001, pursuant to RBI directives, inspection of UCBs was effected once in two years, after that the periodicity will henceforth be once every year.

52. 5.66

It will be seen that almost everything was being wrongly done in MMCB and almost everyone was involved. This case therefore deserve severest action. The Committee recommend the following :—

- (i) The Committee is of the opinion that in the gross irregularities committed in the functioning of the MMCB, everyone was involved. The Committee believe that all those involved must be dealt with severely and expeditiously. The Committee recommend that RBI, State Registrar of Co-operative Societies and Central Registrar of Co-operative Societies should fix responsibilities for wrong doings and proceed expeditiously against all those who are found involved. Had such misdeeds not been committed, the fabric of co-operative Banking system could not have been affected to this extent.
- (ii) The Ministry of Finance must give a serious thought to the problem of duality of control in the case of co-operative banks which in fact is not only resulting in cross directives adversely affecting the working of the co-operative banks but also since most of the State Registrars are not exercising proper control and surveillance over these banks, it is noticed that the co-operative banks often flout rules with a sense of total impunity without the fear of any kind of accountability. The Committee therefore are inclined to agree with

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the recommendations made by the High Powered Committee and desire that the bank-related functions of the co-operative banks should be brought fully under the purview of Banking Regulation Act, 1949, so as to bring a clear demarcation of areas of activities of co-operative banks which will fall under the domain of RBI *vis-a-vis* the Registrar of Co-operative Societies. The legislative proposals submitted by the RBI to the Ministry of Finance as well as the proposal regarding setting up a separate apex body for regulating the entire urban co-operative sector therefore, merits early consideration.

- (iii) In order to prevent irregularities of the type surfaced in the case of some of the co-operative Banks which were examined by the Committee they are of the view that full ban on granting of loans and advances to the directors and their relatives in concerns in which they are interested needs to be imposed. Appropriate legal procedures may be initiated to ensure that there is no conflict of interest in the grant of loans and advances to the directors and their relatives in the concerns in which they are interested.
- (iv) The Committee recommend that stringent laws be put in place to deal with fraudulent transaction like the ones that have come to light in relation to the affairs of MMCB and conduct of its Chairman and other senior functionaries. The laws must ensure that those guilty be brought to book expeditiously and disgorge their ill-gotten gains through confiscation of property and other appropriate measures.
- (v) Penalties under the Banking Regulation Act, 1949 for false return/information must be enhanced to serve as a deterrent.

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5.109

The Committee regret to note that the City Cooperative Bank flouted all prudential norms of the RBI. This became clear during the investigation conducted by the RBI. The Bank had no investment policy, loan disbursement policy and credit appraisal system. Carrying out a concurrent audit was also missing. The Bank had opened deposit accounts in respect of four front companies of the promoter of M/s Century Consultants Group *viz.* Shri Anand Krishna Johari who was also a Director on the Board of the Bank. The accounts were opened without observing the usual safeguards such as introduction, obtaining of Memorandum and Articles of Association etc. The Board had vested full powers of investment on Shri Anand Krishna Johari and all investment decisions were taken by him. The result was that between 5th and 15th March, 2001, the Bank's funds to the extent of Rs. 6.50 crore were utilized for investments in bonds of Cyber Space Infosys—a concern of Shri Johari, contrary to RBI instructions prohibiting equity investment in such companies. There was also a total absence of any loan policy/committee and all credit decisions too were taken only by Shri Anand Johari. The Bank had invested funds to the extent of Rs. 15.68 crore in

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term deposits and receipts aggregating to Rs. 2.62 crore could not be produced to RBI for verification during the investigations. It was noticed that these were however encashed but not accounted for and the proceeds had simply been siphoned off. Similarly, the Bank did not have any documentary evidence in respect of a large amount of investment amounting to Rs. 21.40 crore indicating that the money had been misutilised by Shri Anand Krishna Johari. The advances were disbursed on the orders of the Secretary cum CEO. In addition, advances against shares in physical form were granted in excess of the ceiling of Rs. 10 lakh per individual as prescribed by the RBI which resulted in turning the entire portfolio to the tune of Rs. 1.53 crore into NPAs. Furthermore, the Bank had violated RBI directives on unsecured advances by sanctioning limits in excess of Rs. 50,000 in a number of cases, in blatant violation of the RBI directive on maximum limit in relation to unsecured advances. During the period January-March, 2001, the Bank had sanctioned large advances to the tune of Rs. 5.88 crore to 15 borrowers without the backing of any tangible security in blatant violation of RBI directives. Astonishingly loans were sanctioned even against blank applications and without obtaining signatures on the necessary documents. Advances and funds were released by way of demand draft without ensuring their end use.

54. 5.110 The Bank had reportedly violated RBI guidelines on credit exposure in respect of the individual exposure norms of 20% of its capital fund and group exposure norm of 50% of its capital fund in several cases. The liquidity position of the Bank was extremely unsatisfactory as the deposit liability of the Bank as on the date of scrutiny i.e. 22.3.2001 stood at Rs. 65.90 crore against the liquid assets of Rs. 8.14 crore. The Bank had also circumvented the CRR guideline as laid down under Section 18 of the Banking Regulation Act, 1949. It had adopted a novel way of inflating its balances with notified/eligible Banks in its books of accounts by booking fictitious debit entries. The Committee also note that there was no system of concurrent audit and the Bank had also violated RBI guidelines on income recognition, asset classification and provisioning. This ultimately resulted in systematically siphoning off the Bank's funds to the tune of Rs. 32.30 crore through the companies of Shri Anand Krishna Johari and turning negative the networth of the Bank.
55. 5.111 Neither the State Registrar under whose direct control the Bank functions nor the RBI which is an apex regulator in the case of urban cooperative Banks came to know of the misuse of powers and flagrant violation of regulations/directives of the RBI until a public outcry and news in the press. Though under the UP Cooperative Societies Act, 1965 wide powers of conducting inspections, enquiry and audit are vested with the Registrar of the Cooperative Societies, these powers were not exercised to check the functioning of the Bank. RBI too surprisingly issued licences as late as February, 2001 for opening four more branches of the Bank, thereby giving an impression that the Bank was functioning well. In fact even when in the annual inspection report of 1999, the RBI had clearly

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indicated some glaring irregularities and the auditors of the State Cooperative Department for the period 1997-2000 had pointed out serious irregularities, immediate steps were not taken for rectifying the irregularities. This leaves the Committee with the impression that both the RCS as well as RBI showed laxity in discharging their duties even prior to March, 2001 when the run on the Bank surfaced.

56. 5.112

The Committee were informed that RBI has filed criminal complaints against the Chairman, Secretary-cum-Chief Executive Officer and 11 other Directors in the Court of Chief Judicial Magistrate, Lucknow. In addition two FIRs dated 2nd May and 18th May, 2001 were also lodged against the erstwhile Director Shri Anand Krishna Johari and erstwhile Secretary Shri Gorakh Nath Srivastava for siphoning off funds from the Bank in the form of fake investments etc. to the tune of Rs. 30 crore approximately. The second FIR related to siphoning off funds in the form of cheque purchase for Rs. 1.71 crore. These two cases were subsequently taken over by CBI in July, 2001. Whereas in one case CBI has filed a charge sheet, investigations in the other case are not yet over. Departmental proceedings against Shri Gorakh N. Srivastava have also been initiated.

57. 5.113

In view of the foregoing observations, the Committee recommend the following specific action:—

- (i) In order to expedite action on the criminal complaints which are presently pending adjudication in the Court of the Metropolitan Magistrate, Lucknow, it is recommended that such case be tried by a Special Court.
  - (ii) UP Government may be asked to initiate further enquiry against the concerned State Registrars for not being vigilant and exercising supervision on the working of the Bank even when the UP Cooperative Societies Act, 1965 empowers the Registrar to hold an enquiry into the working of the co-operative society, carry out inspection on his own and even supersede the Committee of Management in case it is found that any act is committed which is prejudicial to the interest of the society or its members or otherwise if the society is not functioning properly. This should be done expeditiously.
  - (iii) CBI must complete the investigations expeditiously in the case wherein FIR has been filed for siphoning off funds in the form of cheque purchase for Rs. 1.71 crore.
  - (iv) RBI must introduce a system whereby the irregularities pointed out in the annual inspection Reports are removed by the Banks and compliance report is submitted within a period of six months from the date of inspection.
  - (v) Strict penal provisions be incorporated in the Banking Regulation Act, 1949 for non-compliance of the directives/guidelines issued by the RBI from time to time and in case of default, strict disciplinary action should be initiated against the erring officials.
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- (vi) As an apex body, though it is not possible for RBI to monitor each and every transaction, it is essential that concurrent audit is conducted in the Banks on a regular basis. The Reserve Bank of India may consider making this mandatory.
- (vii) Investigation must be conducted to unearth where the siphoned money (Rs. 32.30 Crore) has been deployed. Expeditious action is needed to recover the money.
58. 5.116 The Committee note that RBI has taken note of the irregularities committed by these UCBs and is taking appropriate action. The various aspects relating to the capital market exposure of some Urban Cooperative Banks in violation of RBI guidelines and the subsequent steps taken by the RBI to do away with the shortcomings in the Urban Cooperative Banking sector and various systematic reforms introduced or proposed to be introduced to strengthen the surveillance and vigilance mechanism have been dealt with in detail under the chapter 'Reserve Bank of India' of this report.
59. 5.156 The Committee note that during the year 2000, the Global Trust Bank's exposure to the Capital Market by way of advances against shares and guarantees issued on behalf of the brokers was relatively higher and the Bank had a very high exposure to a particular stock broker. However, there were no violations of any prudential norms. It exceeded the minimum limit prescribed by the Board of the Bank, each of which was ratified by the Board. Subsequently the Bank brought down the same gradually. It was done only with the intervention of the RBI. RBI advised the ex-CMD to step down and accordingly Shri Ramesh Gelli relinquished his position on 12.4.2001. The RBI subsequently issued a show cause notice in May 2001, followed by a letter of displeasure. At the industry level, it is noted that UTI Bank has also exceeded the relatively high ceilings fixed by the Board and RBI after a scrutiny has expressed displeasure. There were also other banks who had significant exposure to capital market namely, HDFC Bank, Bank of Punjab, Centurion Bank and Bank of Madura (since merged with ICICI Bank). Also, three Banks, viz., Karnataka Bank, Bank of America and Development Credit Bank, had exceeded the 5% limit of investments in shares, etc. as of 31.1.2000.
60. 5.157 The Committee also note that the guidelines issued by the RBI in November, 2000 had provided that a bank's exposure to the capital market by way of investment in shares, convertible debentures and units of mutual funds (other than debt funds) should not exceed 5% of the bank's domestic advances as on March 31, of the previous year. It was not considered necessary to prescribe an overall ceiling for advances against shares and issue of guarantees on the ground that the shares are taken as security and are subject to market discipline. The decision in this regard was left on the Boards of the individual banks. It was only recently in May, 2001 when fresh guidelines on the subject have since been issued by RBI and the Bank's exposure to capital market has been further regulated. The Committee is of the
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view that RBI should have been proactive in prescribing exposure limits to brokers, particularly after having done so in terms of exposure to investments in shares, etc. and IPO financing. Additionally, RBI should periodically monitor exposure of banks to sensitive sectors.

61. 5.158

Cases have also reportedly been filed before the Debt Recovery Tribunal for recovery. The Committee were also informed by the RBI that the diversion of funds is not a specific violation under the Banking Regulation Act.

62. 5.159

In view of the foregoing the Committee recommend the following:—

- (i) Action for recovery of the outstanding advances which have been diverted and the other advances which have now been categorized as NPAs be expedited.
- (ii) In case there is any dereliction of duty on the part of the Bank Auditors, the same may be referred to the Institute of Chartered Accountants of India for further enquiry and appropriate action.
- (iii) Even though there were no breach of regulations, it was observed that certain loans were sanctioned without comprehensive evaluation and therefore, the bank must ensure that proper credit appraisal and monitoring system is in place.
- (iv) The procedural working of the banks must be strengthened and the RBI must ensure that the rectification, if any, takes place in a time-bound manner.
- (v) In the immediate aftermath of the Stock Market crash, RBI focused on one new private bank although other private banks also had large exposure to the capital market including some who had exceeded RBI limits. Now that substantial information is available about all the banks concerned, the Committee recommend RBI undertake a thorough review and process matters relating to all concerned in a uniform and consistent manner.

63. 5.174

The Committee take a serious note that the Bank of India did not follow laid down rules, procedures and norms. The Committee specifically note that the Bank of India :—

- (a) delegated unlimited power to the Branch Managers/officials of the Bank in respect of discounting the pay orders without weighing either the financial standings/status of the counter party Bank or the track record of the client. While observing this, it is recognized that though the delegated powers stood the test of time over a period of about 15 years, the Bank could have revised this and that the Reserve Bank of India could not detect the unlimited powers so given by the bank, during the Annual Financial Inspections conducted by it for so many years and further that the Board of the Bank which included representatives of Government and RBI had approved these delegations;

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- (b) did not prescribe any system of reporting these transactions by the Branch to the controlling office through an omission with the result that the latter remained totally oblivious of what transpired down below;
- (c) despite detailed instructions issued by the RBI, the Bank had discontinued concurrent audit of its Mumbai Stock Exchange Branch after October, 2000 and the same was not re-introduced till June, 2001;
- (d) no regular audit of the branch took place after November, 1999;
- (e) no effort was made to exercise control and to put the risk management measures in place and guidelines issued by the RBI on the subject were flouted with impunity. While observing this, it is recognized that Bank of India had in place risk management measures comparable to other peer banks in the industry and that it did not have a counter-party bank exposure limit for discounting of pay orders, just as many other peer banks;
- (f) although the Mumbai Stock Exchange branch was handling large volumes of business, mostly sensitive in nature being related to capital market transactions, an officer (Shri U.H. Somaiya) with a tainted record was posted as AGM in this branch during November, 2000 who in turn allowed large scale discounting of high value pay-orders issued particularly in favour of Ketan Parekh group of companies by MMCBL and ultimately this resulted in a big pecuniary loss to the Bank to the tune of Rs. 129.66 crore as on 25.7.2001. The fact that while discounting a large number of pay orders, he even did not think it prudent to heed the advice tendered by the Accountant of the branch and also ignored the reports appearing at the point of time, in different newspapers regarding the financial problems being faced by Shri Ketan Parekh, puts his role under suspicion. While observing this, it is recognised that the punishment given to Shri U.H. Somaiya for lapse committed by him earlier in the Bank was a minor one and that it did not bar him in being considered for the post of AGM of the Stock Exchange Branch as per internal rules of the Bank and the Bank had posted him as AGM of the Branch having regard to his exposure as Managing Director of Bank of India Shareholding Corporation. In this connection, it should be necessary to carry out further inquiry regarding financial benefits reaped by Shri U.H. Somaiya, his present wealth and the mode of acquisition.
- (g) The Committee is unhappy that the management did not care to hold all those responsible who were at the helm of affairs and were more responsible to ensure that the Bank functioned on prudent business principles and directions of the apex bank are followed stringently. No action, for instance, was taken against the
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Zonal Manager for his failure to alert the Head Office. Concurrent auditor was also not appointed for months together. For this lapse there is a case for proceeding against the Zonal Manager.

64. 5.175

The Committee note that though as subsequent corrective measures the Bank has now stopped discounting pay-orders of any cooperative bank and have fixed counter-party limits/prudential limits for different categories of persons in the case of demand drafts, the major problem of overcoming the settlement risk which is reported to be the main cause behind this huge loss still remains to be addressed to by Reserve Bank of India and the Indian Bankers' Association. The Committee, therefore, recommend the following action:—

- (a) Technology be improved with a view to ensuring that counter-party risk gets minimized through the introduction of real time gross settlement system, so that the whole payment and settlement system gets integrated. With a view to ensuring that such failures do not take place in future this must be accorded top priority;
- (b) Disciplinary action be taken against all those who were supposed to exercise due diligence in the discharge of their duties and have failed to do so. Investigations be made to find out if Shri Somaiya or any other official of the Bank had colluded with Shri Ketan Parekh and in case it is proved, criminal proceedings be launched against all those who are responsible for causing wrongful loss to the Bank;
- (c) Efforts for recovering the balance amount of Rs. 129.66 crore be speeded up.

65. 5.195

The Committee note that the management of the Nedungadi Bank embarked on a scheme of arbitration which envisaged purchase and sale of shares by taking advantage of price differential between NSE, BSE and other Exchanges through a set of three broking firms without adequate diligence on their part. All the three broking firms were closely connected with Shri R.K. Banthia which together held 22.19% of the paid up capital of the bank. This action of the management caused pecuniary loss to the Bank. According to the scheme, the shares were to be sold and purchased on the same day. This was not done with the result that at the end of March, 2000 it was found that about Rs 94.52 crore were outstanding from the brokers. After recovery, subsequently, an amount of Rs. 21.10 crore is still outstanding. This outstanding amount was surreptitiously shown under the head of 'other assets' in the balance sheet of the Bank and even the auditors failed to point out such a glaring discrepancy in the accounts. The Committee also note that contrary to all ethical practices, the brokers who had substantial stake in the Bank were instrumental in granting huge advances to their own kith and kin with the result that the Bank got saddled with huge non-performing assets.

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66. 5.196 In this respect the Reserve Bank of India did not take timely notice of this irregularity. When RBI was informed that the scheme had been implemented on experimental basis, instead of stopping the scheme immediately, the RBI took their time and did not take prompt decision. Even when the Board was informed of the arbitrage transactions, the RBI's nominee Director did not raise the question of suspending arbitrage transactions. Besides, from the record placed before the Committee they find that the representative of the RBI while deposing before the Committee, did not place the correct facts before them. All along, it was stated by him that the RBI was not informed about the implementation of the scheme and the matter was not placed by the Bank before the Board, whereas the facts placed on record before the Committee speak otherwise. The Committee take a serious note of this. After having examined the witnesses and going through the evidence placed before the Committee, they conclude that there was an attitude of total apathy on the part of the RBI with the result that funds were manipulated and misused by a few brokers who alone had a turnover of about Rs.1350 crore to their sole advantage during the relevant period.
67. 5.197 The Committee note that though criminal proceedings have been filed against the ex-Chairman who has since been dismissed, but no such action has been taken either against the Directors or against the Senior Manager of the Investment Cell who is reported to be absconding. The Committee recommend:
- (a) Appropriate action should be initiated against Directors and senior manager of the Investment Cell for having committed a breach of trust and causing wrongful loss to the Bank.
  - (b) Expeditious action be taken to recover the balance amount of loss to the tune of Rs. 21.10 crore caused to the Bank, from Shri R.K. Banthia, broker-Director, Shri Srikant G. Mantri, broker and Shri H. Ganesh, Senior Manager of the Investment Cell, pending final disposal of their case.
  - (c) An amount of Rs. 8.72 crore as interest due on account of delayed payment of sale proceeds should also be recovered from the brokers Shri R.K. Banthia and Shri Srikant G. Mantri.
  - (d) The SEBI should expeditiously complete their investigations in respect of the brokers Shri R.K. Banthia and Shri Srikant G. Mantri and take appropriate action.
68. 5.212 The Committee deeply regret that those holding executive positions in the stock exchanges were not only operating the bank accounts of the exchange but they were themselves major brokers operating the share market. The default that occurred in CSE is directly attributed to this nexus and the failure of the IndusInd Bank to return the dishonoured cheques in time.
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69. 5.213 The Committee note that delayed intimation regarding the dishonouring of four cheques amounting to Rs 15.30 crore by the IndusInd bank to CSE resulted in making a pay-out by the CSE under the mistaken belief that the cheques had been duly credited and this in turn precipitated the payment crisis which took place in the Calcutta Stock Exchange. Though both the Calcutta Stock Exchange and the IndusInd Bank have tried to put the blame on each other, but the fact that the Bank in this case did not return the dishonoured cheques to the Margin Department of the Exchange, transgressed from the customary banking practice of sending the cheques back to their client within 24 hours and instead sent their representative to the President of the Stock Exchange and then abided by the advice given by him to withhold the cheques, leads to suspicion towards the role played by the Bank as a professional banker. Likewise it can also not be accepted that the officials of the Calcutta Stock Exchange were totally ignorant, more particularly when in one of the letters, their Executive Director himself admitted the fact that the representative of the Bank had contacted their Vice-President who had in turn advised him to see the President and give the list of the members together with the amounts to be debited. This fact has further been corroborated by the member of the Executive Committee. On the basis of the entire evidence and record placed before the Committee, they are inclined to infer that there was collusion between the Bank and the broker.
70. 5.214 The payment crisis in CSE concerning IndusInd Bank leads the Committee to recommend that:—
- (a) Specific guidelines need to be issued by RBI to all clearing banks regarding the procedure to be followed in respect of dishonoured cheques from Stock Exchanges.
  - (b) Till Demutualisation is put in place for all the Stock Exchanges, Executive Director or the Secretary or Treasurer, as deemed suitable, may be vested with powers to operate the accounts.
  - (c) There is sufficient evidence for the Committee to believe that there was a collusion between IndusInd Bank, CSE and brokers concerned. Any lapse in this regard must be dealt with.
71. 5.223 It appear to the Committee that Centurion Bank has been transgressing prudential norms of banking and have been taking large exposure to capital market, both by way of loans and direct equity investments. The Committee have noted following observations of SEBI:
- (a) Involvement of Centurion Bank, where the broker and the buyer are Ketan Parekh entities in every transaction.
  - (b) The Bank seems to have participated in manipulative trades.
  - (c) According to SEBI report, transactions suffer from the synchronized deals, cross deals, structured deals and circular deals. There are many transactions of buy & sell on the same day. RBI has clear regulations prohibiting banks from making a sale or purchase without
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giving or taking delivery. Centurion Bank appears to have violated this by buying and selling the shares on the same day.

72. 5.224 The Committee suggest that RBI should ensure that prudential norms are clearly laid down and strictly enforced.

#### STOCK EXCHANGES

73. 6.13 The Committee have perused the Minutes of that meeting and note that the senior SEBI official nominee on the CSE Committee did not attend the meeting called at short notice although the crisis on CSE had become a matter of deep public concern.

74. 6.17 The Committee note that while the Exchange would be "asking for early pay-in of securities/funds", it was not known whether the brokers concerned would be able to do so since the Exchange, as on 12.3.2001, were still engaged in "assessing the situation". It was only "after taking such measures", which were still to be taken, that the Exchange said it "expects to have smooth pay-in and pay-out in settlement No. 2001149."

75. 6.18 Although the media and public opinion in general were exercised about CSE, SEBI, as the secondary but statutory regulator, failed to query any part of the proceedings of the CSE Committee on 12.3.2001. It failed also to anticipate the continuation of the payments problem in CSE beyond its Settlement No. 148 as well as the ultimate magnitude of the payment problem, as reflected in the interventions of the Finance Minister in the Rajya Sabha on 13.3.2001. The Executive Director's report on how pay-in/pay-out was effected in Settlement No. 2001148 and the CSE Committee's expectation of a smooth pay-in/pay-out in the next settlement was accepted at face value and passed on as such to the Finance Minister.

76. 6.19 The Committee are of the considered view that, at bottom, the payments crisis on CSE arose because the SEBI with the consultation of the Ministry of Finance had permitted the resumption of badla without arranging for curbing or regulating rampant off-market "internal badla". SEBI should have ensured the rectification of the errors revealed in SEBI's own inspection reports. The UTI Chairman was used or persuaded to exercise his discretion to bail out the pay-in by making massive purchases of dud shares owned by the defaulting brokers, inflicting serious losses on small investors who looked upon UTI as a government-regulated mutual fund. Everyone concerned—the Ministry, the Regulator, CSE—ought to have seriously addressed themselves to the systemic deficiencies in CSE when its turnover was exponentially increasing. They did not because, it would appear, no one was interested in intervening when the going was good.

77. 6.94 The Committee find that the payment problem in CSE in March, 2001 was primarily due to high concentration in a few scrips by a few brokers and a general failure of the Exchange in terms of surveillance and risk
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management. These in turn owed their existence to the weaknesses in the system due to conflict of interest in the case of broker Directors. The total pay-in default of Rs.120 crore during the crisis was met by utilising the Settlement Guarantee Fund and from other resources of the Exchange. This is stated to have impacted the reserves of the Exchange to the tune of Rs.11 crore. Although SEBI has claimed that all investors got their due amount or securities on time and that there was no possibility of any adverse impact in real terms on other Stock Exchanges or the overall Stock Market, the Committee note that the payment crisis did affect market sentiment all over the country. As is evident from the succeeding paragraphs of this section, there has been obvious laxity in surveillance and gross violation of exposure controls and risk management measures. Payment crisis in CSE was not an isolated incident. It must be viewed from the overall manipulations of stock markets in India by various players of which Calcutta brokers became surrogates. These players included key brokers, corporate houses behind the brokers and broker directors of CSE. The payment crisis in CSE is due to wilful inaction of CSE and SEBI and involvement of banks.

78. 6.95

The Committee cannot but express its dismay at the way the stock watch surveillance system was rendered largely ineffective since June, 2000 by the steep upward revision of the bench mark for generation of alerts from the trade size of 20,000 to 90,000. Further, even the few alerts generated by the surveillance system in case of volatile and active scrips were either ignored or not pursued seriously by the CSE and no pro-active role was taken by the CSE to find out the nature and likely impact of Members' matching trade and shifting of positions in circular fashion. Thus, the CSE crippled the surveillance mechanism and facilitated brokers to prefer concentrated positions in certain scrips.

79. 6.96

The Committee find that the CSE had been permitting its members to violate the exposure limits and avoid margin payment, thereby defeating the very purpose of the risk management systems. According to SEBI, CSE could have prevented the "payment crisis", had it strictly followed the SEBI directives on margins and exposure limits. The gross exposure limits were violated in two ways. By the first method, the CSE's computation of gross exposure used to exclude the long position crystallised at the end of the previous settlement in violation of SEBI's instruction of 2.7.1999. The case of non-inclusion of crystallised delivery to the tune of Rs.161 crore on 1.3.2001 in respect of one broker illustrates the extent to which the gross exposure by brokers exceeded the limit. By the second method, while computing gross exposure limits of the brokers, CSE was avoiding deduction of the additional capital which had been utilised against marginal liability. Consequently, violation of exposure limits by some brokers on this account ranged between Rs. 48 crore and Rs.109 crore prior to their pay-in default. Such wilful violation of risk management systems cannot be accepted from any quarter.

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80.	6.97	The margin money collected by CSE on gross exposure of brokers was substantially lower than the required amount due to a software error. The programme module used to erroneously report zero in place of all values larger than Rs. 2.14 crore (approx.). The under statement of gross exposure margin varied from day to day and it was as much as Rs. 50.38 crore on 1.3.2001 out of which the under-statement pertaining to one defaulter broker alone was to the tune of over Rs.11 crore. The brokers including broker directors were aware of the software error and avoided reporting the matter to the Exchange. This reveals the collusion and connivance among all concerned. The Committee cannot accept the then Executive Director's plea that he had no knowledge of the error which had been prevalent since December, 1999. The Committee, therefore, recommend that this be thoroughly investigated and appropriate action taken.
81.	6.98	The estimation of margins was made by the margin module of C Star software developed and maintained by CMC Ltd. Though the defect has been rectified by CMC on 16.04.2001, the Committee feel that the extent of the responsibility of CMC and others for the software error needs to be investigated.
82.	6.99	Though the Exchange was supposed to deactivate the trading terminals of brokers who had not paid the margins on T+1 basis, CSE delayed the deactivation of their terminals. The delay ranged from 4 to 9 days in eight cases and had enabled the brokers to build up further positions to the extent of Rs.190 crore. The Committee agree with the then SEBI Chairman that this was a clear case of collusion. Though SEBI has been emphasising in its annual inspection reports right from the year 1998 that CSE should have connectivity with the clearing banks for a system of direct debit, CSE is stated to have introduced the system of direct debit only after the 'payment crisis'.
83.	6.100	The Committee are astonished to note that the CSE had appointed all the 9 broker Directors as honorary treasurers and authorized them to operate all the bank accounts signed by any two of them. This arrangement was bound to lead to corrupt practices. The Committee hope that as assured by SEBI, steps would be taken to correct the system.
84.	6.101	Another area in which CSE failed miserably is in enforcing its own rules concerning the trading and carry forward limits. Though the CSE had fixed trading and carry forward limits, these were violated with impunity. All the defaulting groups had violated trading limits set up by the Exchange around the period of the payment crisis. The number of violations was as high as 144 during 20 settlements, out of which one member alone accounted for 64 instances of violation. However, no disciplinary action worth the name had been taken against any of the violators under the rules of the Exchange.

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85. 6.102 Yet another area which contributed to the payment crisis in CSE was private deals between individuals, commonly known as 'illegal badla' which remained outside the purview of regulatory supervision of the Exchange. The Committee note that SEBI has been emphasizing in all its inspection reports that CSE should streamline the system of reporting and recording of all the off the floor transactions. However, no meaningful action had been taken by the Exchange nor had SEBI ensured implementation of its suggestions. The Committee deprecate the indifference on the part of both the Exchange and the regulator. The Committee feel that SEBI wilfully overlooked the irregularities committed in this regard. Incidentally, the power of CSE to impose fine on the offenders in this regard was a paltry amount of Rs. 25,000/-. The efforts of the Exchange to enhance the level of penalty met with stiff resistance at the Annual General Body Meeting held on 26.9.2000. It was only on 12.9.2001 SEBI issued direction to CSE to amend its Articles of Association to remove the cap on the fine and penalties.
86. 6.103 Looking at the future, illegal financing in various forms appear to be resurfacing in stock exchanges like Ahmedabad. Synchronized deals and gathering of brokers at a fixed time on a particular day in a week in trading hall of the exchange/corridors of the exchange to fix badla charges is common knowledge. There is need for SEBI to take immediate action. Also, some large and influential brokers of BSE/NSE appear to have recently started funding their clients and other operators taking shelter under a specific circular of SEBI incidental/consequential to their securities business. SEBI needs to come out clearly on such transactions. SEBI should crack down immediately on such modes of financing which is getting prevalent across the country. Otherwise crisis of the CSE type will re-emerge on BSE, NSE, Ahemdabad and other stock exchanges soon.
87. 6.104 The Committee are concerned to learn that the deficiencies in the working of CSE were not of recent origin. SEBI's report a decade ago had found numerous deficiencies including absence of a mechanism for monitoring margins. On the basis of an enquiry into the affairs of CSE in April, 1994, it was recommended that the Board of the Exchange should be suspended. The problems of CSE as seen by this Committee appear to flow from the culture of non-compliance with rules, regulations and transparent practices. This appears to have developed over a period of time. In 1994 it was recommended that the Board of the Exchange should be suspended because of gross malpractices. After reviewing the position, however, the SEBI did not suspend the Exchange or take any severe measures as to shake up work culture of the exchange. The Committee's examination has, however, shown that nothing changed in CSE. Instead, things went from bad to worse. It is clear that despite knowing the track record of CSE, SEBI did not take timely corrective action. The Committee are of the view that SEBI should have played a more proactive role in the affairs of CSE and curbed malpractices well
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- in time. The SEBI failed to do so. Officials of Surveillance Department of SEBI dealing with CSE are also similarly responsible. SEBI's lapses should be investigated and accountability be fixed.
88. 6.105 It was the responsibility of the Executive Director to run the day-to-day administration and to enforce the Articles, Bye-laws, Rules and Regulations of the Exchange as well as to give effect to the directives, guidelines and orders issued by SEBI. The Committee note that the Executive Director, however, did not have adequate powers to control the members and run the day-to-day affairs of the Exchange, and there had been interference by the elected board members in the day-to-day matters of the Exchange. The Committee feel that the remedy for the ailment of the Exchange is demutualisation. This would also enable strengthening of the regulatory and supervisory framework of the Exchange and would go a long way in the protection of investors. The Committee stress that urgent measures need to be taken in this direction.
89. 6.106 The Committee, *inter-alia*, recommend the following:—
- (i) After determining the extent of their involvement, appropriate criminal penal action should be taken against the defaulting brokers, especially those who were broker-Directors of CSE, for exposing the investors and the Exchange to grave risks by their criminal negligence/deliberate failure to initiate steps for rectification of short collection of gross exposure margin by the Exchange, despite their personal knowledge about the fraud.
  - (ii) A thorough investigation against the then Executive Director be instituted and completed within three months to determine his criminal negligence and dereliction of duty in the affairs of the Exchange that led to major failure of the CSE. On the basis of outcome of the enquiry, suitable action be taken forthwith.
  - (iii) SEBI should remain vigilant to ensure that illegal financing does not restart in various Stock Exchanges.
90. 6.148 SEBI's instructions regarding Surveillance issues appear to be conflicting. While its instructions in August, 1995 stipulated that the Surveillance Department of the Stock Exchanges should be directly under the Executive Director with a view to insulating the surveillance system from broker office-bearers and broker Directors, its directive in August, 1996 required that Governing Boards of the Stock Exchanges should review the functioning of their Surveillance Department. This ambiguity in the SEBI's instructions apparently has led BSE to include broker directors in the Surveillance Committee constituted in May, 2000. The Committee urge SEBI to look into these obvious contradictions in its circulars and issue suitable instructions clarifying the position.
91. 6.149 The Surveillance Committee of BSE although constituted on 25.5.2000, did not hold any sitting for over 7 months. The Committee find that it
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was during this period that the market manipulations and irregularities were taking place. It is inexplicable why having constituted a Surveillance Committee, the BSE did not make it functional for a long time. Review of surveillance functions by an Exchange is an important area in the context of investors protection. The Committee feel that the institutional mechanism in the Stock Exchanges to undertake review of surveillance functions should be made purposeful and effective by holding periodical meetings and reviews. The Committee are also of the view that report on functioning of Surveillance Committee should be submitted by Stock Exchanges to SEBI every six months.

92. 6.150 The Committee are of the view that obtaining trade related information from the Surveillance Department by a broker director holding official position in a Stock Exchange is in violation of norms. It is evident that the trade related information obtained from the Surveillance Department by the then President of the Stock Exchange, Mumbai (BSE) on 2/3/2001 was price sensitive. It is clear that he had in the past too sought to obtain similar information from the Surveillance Director. Such acts are in violation and have the effect of eroding the confidence of investors in the working of Securities Market. This episode underlines the urgent need for demutualisation of Stock Exchanges. The Committee note that as a first step in this direction, SEBI has recently issued a directive prohibiting broker-directors from holding the position of President, Vice-President or Treasurer of a Stock Exchange. The Committee urge that as discussed elsewhere in this report demutualisation exercise should be completed early.
93. 6.151 The Executive Director of the Stock Exchange is vested with the responsibility for the proper and independent functioning of the Surveillance Department. It is shocking to note that the then Executive Director of BSE did not consider the instances of the then President seeking information from the Surveillance Department objectionable. The Executive Director admitted that the information obtained from the Surveillance Department by the then President on 2.3.2001 was "sensitive". The fact that he had not thought it fit to place this fact before the governing body of the Exchange shows that either this was common practice or there was collusion between the then President and the Executive Director. All these cast doubt on the integrity and effectiveness of the Executive Director and call for strict action.
94. 6.152 Shri A.A. Tirodkar, the then Director of Surveillance in BSE was the person responsible for bringing to light the sordid affairs concerning the then President of BSE. The Committee are distressed to note that Shri Tirodkar was asked to proceed on leave and was initially subjected to an in-house enquiry and later by an independent enquiry. The independent enquiry has although recently exonerated Shri Tirodkar, has given the option to BSE to terminate his services. It should be ensured that Shri Tirodkar is not victimized by the BSE. Whistleblowers should be given protection so that wrong doings in any institution can have an attitude
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- without fear. The Committee found that a very timid and helpless attitude was prevalent at all the levels in stock exchanges.
95. 6.153 That the governing body of BSE passed a resolution expressing complete confidence in the integrity of the then President even while his wrongful activities were brought to public knowledge is something disquieting. Such a resolution amounted to pre-empting an enquiry against the latter and handing him over a clean chit. It is a matter of concern that the SEBI Nominee Director too was a party to that resolution though he retracted his stand four months after passing that resolution. The role and functions of SEBI nominee Director in a Stock Exchange ought to be clearly laid down.
96. 6.154 The Committee note that Automated Lending and Borrowing Mechanism (ALBM) of National Securities Clearing Corporation Limited (NSCCL) introduced in February, 1999 was modified within 10 months in December, 1999. The modified ALBM incorporated features of deferral product and it did not have risk containment measures which are normally required in this regard. The Committee expect NSE to exercise due care and caution and observe due process before introduction/modification of a scheme keeping in view the larger interests of investors.
97. 6.155 SEBI's handling of the issue relating to the revised ALBM leaves much to be desired. Though NSE had filed revised scheme with SEBI in October, 1999 and operationalised it in December 1999, *i.e.* after two months, SEBI did not consider the proposal for revision even though the carry forward character of the revised scheme had become known to them in early January 2000 itself as is evident from the perusal of the file submitted by SEBI. They also did not think fit to stop the operation of the Modified Scheme even after realizing that the modification involved great risk to the investors. The apparent lack of risk management measures in the revised ALBM should have led SEBI to take immediate corrective measures. It took seven months for SEBI to decide that the issue needed to be examined by an expert group. The Group appointed for this purpose under the Chairmanship of Prof. J.R. Varma submitted its report in July, 2000 and on the basis of its recommendations SEBI prescribed some risk containment measures but adequate risk management measures were still not put in place till October 2000, when it finally accorded its approval to revised ALBM scheme. Even then the risk containment measures prescribed by SEBI were not completed. SEBI permitted withdrawal of securities from the clearing house under the ALBM despite the fact that the G.S. Patel Committee which went into the issue of reintroduction of "badla" had categorically recommended as early as in 1995 not to permit withdrawal of securities under the Modified Carry Forward Scheme. It was only in February 2001, SEBI rescinded the provision for withdrawal of shares from the clearing house under the ALBM.
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98.	6.156	One of the terms of reference of the Varma Group was to determine whether the modified ALBM introduced by NSCCL was in conformity with the Stock Lending Scheme. The Group has not given its report on this aspect so far. The Committee are at a loss to understand the inordinate delay in this regard.
99.	6.157	The Committee note that the amount of funds deployed by one player in ALBM, BLESS and Vyaj Badla financing was as much as Rs. 1900 crore towards the end of February, 2001. These funds were not deployed in the market between 28.2.2001 and 7.3.2001 and was reduced to Nil. It was initially stated that the non-deployment of funds by the player from the market was due to continuing reduction in interest yields, business requirements, increased volatility in the stock markets etc. Subsequently, it was contended that their orders in the market worth Rs. 780 crore did not get executed though their total investment offered in 28.2.2001 was in excess of Rs. 1700 crore. In Committees' view, whatever be the reason for non-deployment, such huge withdrawal of funds from the market could cause adverse impact in the market.
100.	6.158	Though SEBI discontinued ALBM and other deferral products w.e.f. 2.7.2001, SEBI did not initiate any investigation of ALBM after the crash. It was only at the instance of JPC that SEBI took up investigation of ALBM and came out with a detailed report after persistent and probing questioning by the JPC. The Committee would expect SEBI to be more alert in the performance of its functions. They would also expect SEBI to provide more checks and balances and exercise better regulations for all financing schemes relating to the stock market in future.

#### ROLE OF PROMOTERS AND CORPORATE ENTITIES

101.	7.3	When the Committee enquired about the work of the Special Cell since December, 1994, the Committee realized that no progress worth its name had been made. The Special Cell was almost defunct as dealt with in paragraph 3.12 Chapter III. The Committee note with disappointment the laggard manner in which the recommendations of the previous Committee were treated. Not only this, the Committee consider such an approach as symptomatic of the non-serious attitude of various regulators who hesitate to take action when required, and do so only when prodded. Regulatory authorities must shed their lackadaisical and negative mindset, especially in the context of regulating the stock market, the rise and fall of which not only determines the fortunes of many but the health of which should symbolize the health of the state of the economy. One of the root causes of the scam is this mindset.
102.	7.4	The failure in investigating into the role of promoters and corporate entities while share prices of particular scrips were being artificially manipulated has been attributed by SEBI to the absence of authority to investigate into their role under the Securities and Exchange Board of India Act, 1992. Under Section 11(2)(i), SEBI is charged with responsibility

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of calling for information, undertaking inspections, conducting enquiries and audit of the stock exchanges, mutual funds, other persons associated with the stock market, intermediaries and self-regulatory organizations in the stock market. Though it may be possible to contend that SEBI did not enjoy the authority to directly investigate corporate entities which might have, through various channels, provided funding in the stock market. That the promoters and corporate entities were, at the relevant time, playing a significant role cannot be denied. The Department of Company Affairs, one of the entities having regulatory authority could have, had it informed itself of this or been alerted to the role of promoters and corporate entities, taken timely action in the matter. Diversion of funds allocated to specific projects for use in the stock market for the purchase of specific scrips, investment companies operating in the stock market through brokers, nexus between brokers and corporate entities in the context of the interests of brokers in specific corporate entities, which facts have now come to light, establish the nexus between brokers and corporate entities. The proximity of promoters and brokers is also established by the frequency with which both acted in collusion by the use of circular trading in respect of shares of certain companies, with the sole objective of creating an impression that the scrip in which circular trading is effected was heavily traded; consequently enticing innocent participants in the stock market to purchase the scrip of that company. These and other factors contributed largely to the artificial inflation of share prices in specific scrips, particularly known as the "K-10 stocks" which, in turn, contributed in large measure to a sentiment being created in the market which enthused others to invest solely in these specific scrips and the stock market in general.

103. 7.51 SEBI furnished four sets of interim reports inclusive of its investigation regarding scrips of certain corporate bodies. The Committee's insistence for SEBI's final findings regarding the role of promoters/corporate bodies in the price manipulation of the scrips yielded yet another set of reports most of which were again of interim nature and were received as late as in November 2002. Due to non-availability of Final Report from SEBI, the Committee could not have the opportunity to take oral evidence of these corporate bodies. The Committee urge SEBI, the Department of Company Affairs and other investigative agencies to expedite and complete their investigations into involvement of promoters/corporate houses in manipulation of prices of scrips which were found to have undergone unusual volatility. The Government should take appropriate action under the provisions of the relevant laws on the basis of outcome of their findings. Expeditious action should be taken against those involved wherever the involvement of promoter/corporate house is established.
104. 7.52 The Committee note that SEBI has not completed its investigation in most of the cases even 18 months after taking up the cases for enquiry. The Committee feel that there should be reasonable time frame for concluding investigations that have bearing on the health of the capital

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markets. The Committee desire that SEBI must examine the matter and fix a time frame for investigations as part of its regulations/procedures. SEBI has stated that further evidence against other broker entities, promoters etc. are being recorded and quasi judicial proceedings are in progress. A final view in the matter would be taken after gathering evidence during the course of cross examination of charged entities and on completion of quasi judicial proceedings.

105. 7.53 Having learnt about the ingenious ways of transferring funds by certain companies to manipulate the market, SEBI has now made certain suggestions to prevent proliferation of shell companies. In order that the scope of registering shell companies with fictitious details about their initial subscribers/promoters, their addresses etc., appropriate revisions in the rules as well as in the forms prescribed under the respective rules also need be effected by Registrar of Companies and other statutory authorities in the existing ones and introduce adequate verification of the details furnished in applications for registration of companies, without delay. The SEBI suggestions include yearly declaration by companies about floating of subsidiary/associate companies, etc., disclosure on quarterly basis about change in investments by the subsidiaries/associate companies, restriction on floating investment companies by a parent company and verification of the antecedents of the persons behind the investment companies. SEBI has also suggested regulation of reverse merger where an unlisted company merges with a listed company on non-transparent manner. The Committee are of the view that these suggestions merit urgent examination and follow up action by the Government. The Committee also feel that the issues concerning preferential allotment and private placement also need to be looked into afresh by DCA and SEBI in the light of the SEBI's findings in this regard with a view to take suitable corrective measures.
106. 7.54 This Committee hold that even as there are valid reasons to believe that the corporate house-broker-bank-FIIs nexus played havoc in the Indian capital market quite sometime now through fraudulent manipulations of prices at the cost of the small investors, this Committee were severely handicapped in the matter of making any purposeful recommendations because of non-availability of required support from concerned regulatory and other bodies with necessary material. The issue acquires added importance in view of the recommendations of the 1992 JPC regarding the urgent need to go into this unhealthy nexus of corporate entities-brokers-banks and others.

#### OCBs AND SUB-ACCOUNTS OF FIIs

107. 8.76 SEBI's investigations have brought out several instances of violations by OCBs such as non-delivery of shares, purchase of shares on adjustment basis, booking purchase orders without sufficient balances in their accounts, exceeding the prescribed ceiling of 5 per cent for individual OCBs and violations of 10 per cent aggregate ceiling, etc. Certain

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- OCBs and sub-accounts of FIIs also violated the SEBI (Substantial Acquisition of Shares and Take over) Regulations. SEBI has mentioned five OCBs and two sub-accounts of FIIs which have aided, assisted and abetted in creation of artificial market and volumes, circular trading and building up concentrated positions in a few scrips. SEBI is reportedly taking action against four OCBs and one sub-account for violation of its regulations regarding substantial acquisition of shares. As regards market manipulations by OCBs, SEBI is stated to be examining the matter legally. The Committee urge that SEBI's remaining investigations as well as its legal examination should be completed expeditiously and appropriate action taken against offenders. The Committee note that the Directorate of Enforcement has also since issued show cause notices to the custodian bank and certain OCBs for FERA violations. The Committee hope that final action in this regard would be completed early.
108. 8.77 SEBI has observed that there had been more outflow than inflow of funds which defeated the very purpose of OCBs' portfolio investments, viz., bringing foreign exchange into the country. According to SEBI, the net outward remittances by 13 OCBs during April 1999 to March 2001 were over Rs. 3850 crore. The Committee, however find that this observation of SEBI is based on incomplete analysis which does not include inflows under non-PIS transactions such as sale of underlying shares acquired through the ADR/GDR or FCCB route, shares acquired overseas from other NRI/OCBs or through swaps/purchases. The Enforcement Directorate has pointed out that since the inflow figures of corresponding non-PIS transactions of select OCBs are not ascertainable, no definite inference could be drawn as regards inflow-outflow of foreign exchange. Nevertheless, RBI data indicate that net investments during the past 10 years by NRI/OCBs under PIS alone were over 197 million US Dollars. The Committee would, like RBI to undertake a comprehensive analysis of foreign exchange inflows-outflows by OCBs over a period covering both their PIS and non-PIS transactions and come to a conclusion whether this route is profitable or harmful to our economy. The decision about the ban on OCBs should be based on the outcome of this study.
109. 8.78 The Committee do not agree that RBI should leave it entirely to the custodian Banks to monitor compliance of its guidelines regarding OCBs. There is no system of periodical inspection of OCB accounts of Banks by RBI. RBI claimed that its role was limited to monitoring OCB's company-wise investment ceiling of 10 per cent. The Committee note that RBI's monitoring failed to detect violations of even this limited aspect. It is only after SEBI's investigation that violations regarding ceiling norm came to light.
110. 8.79 It transpired during Committee's examination that there has been no regulatory framework to keep an eye on the activities of OCBs. OCBs were neither registered nor regulated by SEBI. The former SEBI Chairman has gone on record saying that OCBs were not SEBI's responsibility. On
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the other hand, RBI contended that OCBs were not under its regulatory framework. RBI, however, held that if policy framework is laid down by the Government, RBI would be in a position to monitor OCBs. The Committee's persistent query as to which authority is responsible for OCBs has not yielded any specific reply. The Committee note with concern that the Ministry of Finance did not adequately address itself to issues relating to the Mauritius route notwithstanding the growing impact of this Mauritius route on our Capital Market over several years. The Ministry of Finance needs to lay clear policy guidelines about the responsibility to monitor OCBs.

111. 8.80

In the Committee's view, there is a need to have a fresh look at OCBs' operations after an in-depth study of inflows and outflows on a holistic basis covering their PIS and non-PIS transactions. The exercise should also include identification and plugging of loop holes and possible establishment of a proper regulatory set up with stringent penal provisions for violations. The regulatory provisions should *inter-alia* enable detection of cases where same set of individuals have formed more than one OCB and have their investment spread across the OCBs to escape provisions of SEBI's Take Over Code. The Committee feel that the suggestions made by RBI for stipulation of a minimum paid up capital for OCBs and adoption of same registration procedure as applicable to FIs deserve careful consideration by the Government. The Committee would like the Government to review the ban imposed on OCBs in the light of the above and clearly lay down the responsibility to a particular agency to oversee the OCB operations.

112. 8.81

SEBI has expressed suspicion that some of the Indian promoters have purchased shares of their own companies through Participatory Notes issued by sub-accounts of FIs. This mechanism enables the holders to hide their identities and enables them to transact in Indian Capital Market. The Committee note that SEBI has since directed FIs to report about details of the Participatory Notes as and when issued by them. The Committee suggest that failure on the part of FIs to report about issue of PNs should be viewed seriously and should entail stringent punitive action. It should also be ensured that this instrument is not misused in any way to manipulate the Indian Securities Market.

113. 8.82

SEBI has reported that more than 80 per cent of OCBs are registered in Mauritius and some of them seem to act as front for promoters of certain Indian companies. The Committee note that SEBI's attempt to gather information through Mauritius Offshore Business Activities Authority about the actual beneficiaries of suspected OCBs, their source of funds, their net worth etc. has not met with success. There are indications of misuse by the OCBs of the provisions regarding Double Taxation Avoidance Agreement between India and Mauritius, through the enactment of MOBAA. This aspect, as in the past, should seriously engage the attention of the Government.

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114. 8.97 The Committee regret that although Indian concerns about the Mauritius route had been formulated soon after the establishment of MOBAA resulted in substantial financial inflows into India, including money laundering by Indian companies making illegitimate use of the Mauritius route, once the India-Mauritius Joint Commission in February 1997 had endorsed the JWG decision of December 1996, virtually no action was taken to raise and pursue these concerns with the Mauritius authorities although foreign financial inflows into India from Mauritius rose to over Rs.15000 crore, constituting nearly a third of all foreign investment in the country. The Committee are particularly disturbed to note that notwithstanding FM's instructions to his Ministry officials after his meeting with the Mauritius Minister in September 1998, and the offer made to the Indian Finance Minister by the Mauritius Minister in March 2000 to address Indian concerns of receipt origin, little or nothing was done in the Ministry or by the Minister to raise these issues with Mauritius. The Committee are of the view that although the inflow from Mauritius was, in principle, welcome, due care also needed to be exercised about possible misuse of this route. Instances of such misuse have come to light and misuse of the route appears to have been significantly responsible for market manipulations during the boom of 1999-2000 which led to the bust of 2001. The Committee commend the steps taken in July 2002 to amend the DTAA. Continued vigilance on this front will be necessary to prevent scams of the kind that occurred in 1999-2001 when due attention was not being paid to the dangers inherent in the virtually unregulated Mauritius route.

#### SECURITIES AND EXCHANGE BOARD OF INDIA

115. 9.27 Despite the elaborate procedure set out by SEBI for inspection of Stock Exchanges and for taking follow-up action thereon, it had not been able to ensure compliance of its recommendations within a time frame. As a result, the numerous violations/deficiencies brought out in the inspection report of the year 1998 found repeated mention in the inspection reports of 1999 and 2000 and still remained unrectified. Ultimately, these very factors are found to have contributed to the payment crisis of CSE. The Committee fail to understand why SEBI had not thought it necessary to take punitive action in the event of non-compliance of its inspection recommendations within a time frame. The Committee desire that SEBI must evolve an effective system of compliance with inspection findings.
116. 9.28 The Committee note that SEBI's quality of inspection of October, 1999 and September, 2000 was so poor that it could not detect CSE's non-inclusion of crystallised long positions in the outstanding position of brokers although this was clearly violative of SEBI's instruction of July, 1999. The Committee feel that this shortcoming in SEBI's inspection is all the more serious if viewed in the light of SEBI's categorical assertion that had CSE implemented SEBI's instruction, the payment problem would have certainly been avoided.
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117. 9.29 The Committee learn that due to inadequacy of staff, the number of inspection of brokers carried out by SEBI has been gradually coming down from 157 in the year 1997-98 to 103 in 1998-99 and to 80 in 1999-2000. This is not a satisfactory situation and reflects poorly on SEBI. Checking irregularities and malpractices of stock brokers is one of the primary functions of SEBI which could be achieved through the solid instrument of inspection. The Committee urge that SEBI should augment its staff strength, if need be, and progressively increase its coverage of inspection of brokers.
118. 9.30 The performance of SEBI's nominee Directors in discharge of their role is anything but desirable. The attendance record of some of SEBI's nominee Directors in the governing board meetings has also been very poor in as much as one nominee Director in CSE did not attend even a single sitting out of 53 sittings during his tenure from October 1991 to April 1993 and another did not attend any sitting out of 26 sittings during his tenure from November 1996 to June 1998. The Committee note that SEBI has since discontinued the practice of nominating SEBI officials on the governing board of exchanges. The Committee urge upon SEBI to henceforth strengthen its in-house systems and infrastructure and make optimum use of modern technology for carrying out focussed inspection of all aspects of functioning of stock exchanges and follow-up vigorously redressal of shortcomings and deficiencies found out in the inspection reports.
119. 9.31 The Committee recommend the following :—
- (i) The role of Executive Directors in charge of the Secondary Market Division and the Surveillance Division in SEBI during 1999 and 2000 needs to be critically looked into for not ensuring compliance with various actions recommended in the inspection reports of 1999 and 2000.
  - (ii) Explanation be called for immediately from all concerned officials in SEBI who were involved in the task of inspection of CSE during 1999 and 2000 regarding their failure to detect non-inclusion of crystallised long position in the outstanding position of the brokers and action be taken for dereliction of duty.
  - (iii) The poor attendance of SEBI nominee directors in the Board meetings of Stock Exchanges in the past puts a question mark on the efficacy of the system of nominee directors. Although SEBI has since discontinued the system, the Committee desire that the Ministry of Finance should undertake a fresh review of the system of nominee directors keeping in view the proposed demutualisation and corporatisation of stock exchanges.
120. 9.44 In order to improve the surveillance mechanism, the BSE has suggested to the Committee that there should be a centralized surveillance mechanism across all the major Exchanges to oversee the operations of
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		<p>the market participants on a holistic basis. The Committee observe in this connection that although an Inter Exchange Market Surveillance Group set up by SEBI already exists for co-ordination on surveillance related issues it is evident to the Committee that the surveillance system in stock exchanges are heterogeneous or in majority of cases do not exist in any modern form. Surveillance mechanisms both in stock exchanges and in SEBI need to be strengthened in order to prevent a crisis. In most capital markets of the world, there are very strong surveillance mechanisms, first at the stock exchange level and then at the Regulators level. SEBI needs to impart a great deal of urgency in this area.</p>
121.	9.52	<p>The above instance clearly bring out the apathy of the Stock Exchange and an attitude that since "we could not establish it" no further action is needed. This attitude was visible in stock exchanges as also the regulators.</p>
122.	9.64	<p>Yet, SEBI appear to have done nothing particularly substantive about several areas of concern, such as:</p> <ul style="list-style-type: none"> <li>(a) the monitoring and regulation of the Portfolio Investment Scheme and changes therein for OCB and other FII investment in the stock market and not tying up the loose ends in this regard, notwithstanding FIIs having poured in an estimated Rs. 50,000 crore in the stock market since they were permitted to do so in 1994;</li> <li>(b) the mismatch between movement in the primary market and secondary market;</li> <li>(c) the mismatch between the number of listed scrips and the number of actively traded scrips, as also between the number of investors and the disproportionately small number of large brokers capable of moving the market;</li> <li>(d) the rise in private placements to the detriment of the primary market;</li> <li>(e) the absence of any regulator framework for private placements;</li> <li>(f) negligence in checking whether aggressive bull operators during the bull run were overtly or covertly obtaining bank funding to finance stock transactions in the face of regulations designed to moderate volatility.</li> </ul>
123.	9.66	<p>It was SEBI's job to ferret out the irregularities and defuse them before they blew up. This was the primary job of SEBI which they failed to do in time.</p>
124.	9.67	<p>Even as SEBI subsequently take up its investigation into "whole gamut of issues", as Finance Minister told in the Rajya Sabha, it did not set any specific criteria for identification of the entities to be investigated. Clear criteria are the essential prerequisite for ensuring transparency in the matter.</p>

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125.	9.68	Had SEBI been more active on its own and the Ministry of Finance been more insistent on SEBI measuring up to its "macro-accountability to give comfort to the Government that the regulator is performing his job in a professional manner", as stated by the Finance Secretary, much that went wrong in the period under investigation by this Committee might have been forestalled. The Committee regret that a full decade after the establishment of SEBI, and the many years that have passed since the last JPC Report, SEBI's performance has fallen far short of the expectations reposed in it.
126.	9.69	The reasons for the scam will only be discerned if the Committee are able to analyse why the BSE index reached a phenomenal high in February 2000. Absence of an investigation when the BSE index unusually rose contrary to the fundamentals of the stock markets represents the failure of the regulator. Had steps been taken by the regulator at that relevant time, perhaps the phenomenal rise could have been contained and the defaults avoided. The regulator should have known that regulation of the market could only be provided through constant vigil and in cooperation with various other regulatory authorities. There was sufficient contemporaneous evidence to put the Regulator on vigil.
127.	9.70	To some extent, it is valid to contend, as had been done by the SEBI, that it did not have all the powers necessary to deal with the situation that arose in the unusual and artificial rise of the stock market. But the Committee believe that SEBI had sufficient omnibus powers to take preemptive steps had it identified the causes for the artificial rise of the stock market. That SEBI did not even attempt to analyse the problem at the relevant time and sailed along with the so called 'feel good factor', a term used at the relevant time to suggest confidence in the market. SEBI should have acted as an effective regulator.
128.	9.71	The Committee note that the SEBI has not been able to fully investigate the fund flows and the extent of involvement of corporate houses even though NSE had emphasised in its reports forwarded to SEBI on 18.8.2000 the need to study the extent of involvement of the group companies and fund flows that supported the volumes of certain ICE scrips.
129.	9.72	Though the NSE reported about institutional investors' interests in the ICE scrips in August, 2000, the Committee note that SEBI had not undertaken any investigation to ascertain whether there was any abnormality in the institutional interest. SEBI's investigation taken up after the market crash has, however, revealed that certain OCBs and sub-accounts of FIs were misused for parking of shares and creating artificial market.
130.	9.73	The Committee note that BSE had forwarded its investigation report to SEBI on the scrips of two corporate bodies in the month of December, 1999 and February, 2000. SEBI's interim report after the market crash has found that prices of the scrips of those corporate bodies had been manipulated. The price manipulations of these scrips could have been detected and subsequent crisis prevented had SEBI taken timely action.

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131.	9.74	SEBI has stated that the primary responsibility of Stock Market surveillance is with the stock exchanges. The Committee note that the stock exchanges are not yet adequately equipped with fully functional stock watch system. The phase-I of stock watch system which was targeted to be implemented by March, 1998 is stated to be still in the process of implementation. According to the preliminary report of SEBI, the exchanges failed to detect excessive concentration in the market due to the deficiencies in the surveillance mechanism. The Committee urge that bench-marking of parameters, prioritization of alerts and connectivity with various data bases of stock exchanges with standard software systems should be fully implemented and made operational in a time bound manner.
132.	9.75	The Committee feel that the Inter Exchange Market Surveillance Group needs to be strengthened and there should be a formal system of exchange of information among exchanges. SEBI should also view independently consolidated information of trades across all exchanges and generate its own alerts.
133.	9.76	The Committee disapprove SEBI's attempt to abdicate its surveillance responsibility and put the entire blame on stock exchanges for failure to detect market manipulations. Ensuring safety and integrity of the market is a pre-requisite for protection of the interests of investors in securities which is the foremost duty of the SEBI. Market surveillance plays a key role in ensuring safety and integrity of the markets and SEBI ought to undertake market surveillance on its own besides overseeing the surveillance activities of the exchanges. This is all the more necessary given the jurisdictional limitations of stock exchanges in their surveillance and investigations. Therefore, the Committee are of the view that there should be a very strong surveillance mechanism, both at the stock exchange level and at the regulator's level. The Committee recommend that surveillance system both in stock exchanges and SEBI should be examined in a holistic manner with a futuristic outlook. To put a system in place that will be effective in early detection of financial misconduct is an inescapable necessity.
134.	9.77	The Committee feel that SEBI needs to be professionalised with adequate in-house manpower having a sense of belonging and commitment to the organization. There should be adequate manpower assessed on scientific basis to man various positions in SEBI.
135.	9.78	As the economy gets more and more liberalized, the Regulatory authorities will have to become more and more efficient and effective. The key to effective regulation is real time surveillance so that in the first instance and as the first signs emerge there is immediate focus on the misconduct or violation in the securities market like price rigging, creation of artificial market, insider trading and public issue related irregularities. The Committee found total absence of timely alert when the sensx was rising and the volatility in the market had become unusual.

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Frequently, the Committee got the impression that even when considerable indicators were available the regulators failed to step in firmly.

136. 9.79

Any improvement in arrangement for market surveillance should take into account past failure and learn from it. But at the same time the surveillance set up must be futuristic. Far too often, concerned authorities try to plug the gaps that have surfaced in the past without looking at the possible future dangers and requirements. These are :—

- (a) Large number of stock exchanges make the job of surveillance difficult. With the modern reach of IT, the number of functional stock exchanges are coming down everyday. The rule that a company has to be listed on a regional stock exchange should be done away with.
  - (b) All stock exchanges should put a standard stock watch system in place. SEBI should show urgency in this regard. The software should be constantly refined and improved so that the alerts are generated to show abnormal market behaviour and these alerts are available and recorded at the level of stock exchanges and SEBI.
  - (c) The regulators—SEBI, RBI, Enforcement Directorate, IT Department, Department of Company Affairs, at present, keep vital information to themselves and shy away from sharing it with each other. Any of these may be privy to a financial misconduct and their input would be valuable to the other agency. Method for sharing information must be formalized.
  - (d) Misconduct or violation in the market like price rigging, circular trading, creation of artificial market, insider trading and public issue related misconduct should be clearly defined in detail so that exact indicators are well understood and transparent. And these offences should be listed in SEBI regulations with matching punishment.
  - (e) Introduce unique broker and client ID on the lines of PAN in IT Department. Introduce a method of tracking multiple membership across the stock exchanges.
  - (f) Introduce uniform bye-laws for all exchanges.
  - (g) Expedite corporatisation and demutualisation.
  - (h) Surveillance must absorb news and views from all quarters, only then will it get early alert. These sources could be press reports, investors complaints, securities industries sources, stock exchanges and banks. Early alerts and quick action, therefore, is not only the function of formal reports and complaints. Therefore, much will depend not only on stock watch system etc. but the persons who are manning these systems, those who are incharge of surveillance wing.
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137. 9.102 The regulatory gaps amongst regulators may work to the advantage of the violators. Therefore, it is very important to have clearly identified regulatory jurisdictions for each regulator. It is important that the jurisdiction of SEBI is specifically earmarked so that there is no confusion in the minds of the investors.

138. 9.106 The track record of SEBI in punishing the wrong doers in stock market has been unsatisfactory. During the last 10 years, SEBI could initiate prosecution proceedings on insider trading in only one case and on fraudulent and unfair trade practices just seven cases. Its record of taking action against violaters has also been equally unimpressive. In most of the cases, the offenders were let off after 'Warning' or 'suspension'. Only in seven out of 181 cases, SEBI resorted to cancellation of registration during the last four years. All this is indicative of SEBI's reluctance to take severe action against the offenders of stock market. The Committee are of the firm view that only severe punishment can act as a deterrent to the wrong doers and what market needs is fear of punishment and fear of the regulator. SEBI must keep this in mind while handing out punishment to offenders.

139. 9.107 Though SEBI's plea for more powers to strengthen its effectiveness cannot be faulted, the Committee got an impression that SEBI was not fully enforcing the powers already vested with it. For instance, though SEBI has the power to impose a penalty of Rs. 1.5 lakh every time a person fails to furnish the requisite information, rarely has this power been exercised by SEBI. Similarly, the provision for mandatory punishment of imprisonment, etc. in addition to award of penalty has scarcely been used. SEBI has been found wanting in exercise of powers already available with them.

140. 9.108 Notwithstanding the record of poor utilization of powers, the Committee feel that SEBI does experience genuine difficulties in investigation and enforcement due to lack of certain specific powers. These deficiencies had been gone into by Justice Dhanuka Committee. Measures needed for strengthening investors protection have been examined by Dr. N.L. Mitra. SEBI had requested that the following specific provisions might be made in securities laws to enable it to function as an effective market regulator:—

**Investors Protection**

1. Specific right under SEBI Act for investors to approach Courts.
2. Specific right under SEBI Act to investors to claim damages, compensation and interest.
3. Attachment of the properties of defaulting promoters/directors/ companies/entities in a speedy manner.

**Investigation**

**SEBI should have**

4. Specific power of investigation.

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5. Power to impound/retain documents pending investigations.
  6. Power to obtain information:—
    - (a) from the banks
    - (b) from authorities such as—MTNL
    - (c) from legal entities like corporates, promoters, who deal in securities market.
  7. Power to tender immunity from action for making disclosures of facts relating to contravention of regulation under investigation.
  8. Power to obtain information about the source of fund.

#### **Enforcement**

9. Power to take temporary measures—suspension of an intermediary pending investigation, retain proceeds of securities transaction pending investigation, etc.
10. Power to issue Cease and desist order.
11. Power to disgorge the ill-gotten profits made or losses avoided.
12. Power to Impound ill-gotten money.
13. Power to issue directions debarring persons from dealing and accessing the securities market.
14. Compounding/Plea bargaining.
15. Monetary Penalty:—
  - to be enhanced to Rs. 25 crores or 3 times of ill-gotten profit made or loss avoided.
  - to be provided for violations of provisions of SEBI (Fraudulent and Unfair Trade Practices relating to the Securities Market) Regulations, 1995.
  - where no monetary penalty is provided.
  - Monetary penalty against listed companies.
16. Fine and imprisonment on conviction for violation of SEBI Act, 1992/ Regulations through the Criminal Courts:—
  - Fine upto Rs. 25 crores.
  - Imprisonment upto 10 years.

#### **General**

17. Securities Appellate Tribunal be made a multi-member body.
18. Special Court for Securities market.

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19. Number of Board Members in the SEBI be suitably enhanced to include more professional members.
141. 9.109 The Committee are glad to note that the Government have since promulgated an ordinance which, *inter-alia*, has enhanced SEBI's powers of investigation and enforcement. The ordinance has enhanced the monetary Penalty to a maximum of Rs. 25 crore or three times the amount of profits made. Provisions have also been made to make SEBI a nine member Board and Securities Appellate Tribunal, a three member body. These provisions need to be given effect soon for effective functioning of these bodies. The Committee desire the Government to expeditiously examine the feasibility of implementing the remaining suggestions mentioned in the preceding paragraph. The Committee hope that with the enhanced powers and broad based structure of the Board, SEBI will function as an effective regulator in future.
142. 9.110 Clarity is needed between DCA and SEBI in regulating Capital Market. Full fledged responsibility with authority may be given to SEBI. SEBI should be vested with comprehensive jurisdiction over listed companies and also adequately empowered and made accountable for matters connected with listed companies including jurisdiction over accounting standards, corporate governance, mergers and amalgamations and protection of minority shareholders.
143. 9.125 The events that led to the payment crisis in CSE and the episode of Anand Rathi in BSE underline the urgent need for demutualisation of Stock Exchanges. The Committee note that SEBI's Model Rules are in the process of implementation by Stock Exchanges. SEBI has also recently prohibited broker-members from holding any position of office bearer in Stock Exchanges. A group set up by SEBI under the Chairmanship of Justice (Retd.) Shri Kania to examine demutualisation issue has given its report recently. Though the process has started, the Committee hope that SEBI will implement the recommendations of Kania Group expeditiously and as announced by the Finance Minister in his budget speech on 28.2.2002; the process of demutualisation and corporatisation of Stock Exchanges will be completed as soon as possible.
144. 9.126 The Committee are of the opinion that the proposed form of demutualisation should contain a judicious blend of the best elements of NSE pattern and those of other models of demutualisation obtaining in foreign countries so as to safeguard the interests of investors and bring in greater transparency and efficiency of the exchanges.
145. 9.127 The Committee are also of the view that corporatisation of an exchange leading to unbundling of various functions such as surveillance, risk management, clearing and settlement, etc., into a separate subsidiary as proposed by the BSE should not in any way dilute the regulatory functions of SEBI *vis-a-vis* the subsidiaries. The Committee emphasise that the SEBI should extend its proactive supervision on the functioning of these subsidiaries and keep constant vigil in the form of periodic inspections of the activities of subsidiaries.
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146. 9.138 Despite the fact that rolling settlement is beneficial to investors in terms of reduction in risk, cost and settlement time and that its adoption was recommended by 'The Group of 30 countries' as early as in March 1989, the Committee regret to note that SEBI has taken over a decade to develop the infrastructures required for introduction of rolling settlement and for its actual commencement. The Committee note that the settlement cycle has now moved to T+3 system. The Committee feel that with electronic fund transfer facility available in most of the commercial banks the implementation of the Real Time Gross Settlement System (RTGSS) is expected to be completed by March 2003. It should be possible to further reduce the settlement cycle to T+1 system to all scrips. However, this step should only be taken very carefully after RTGSS becomes fully functional even in remote corners of the country and payments timing can match the settlement cycle.
147. 9.151 The Committee are not happy with the way the matters concerning carry forward system were handled. SEBI's stand before the previous JPC was for disallowing carry forward transactions and permitting futures and options. SEBI, however, went about imposing a ban on carry forward transactions in December 1993 without having derivatives viz. futures and options in place. As a result, SEBI had to lift the ban shortly afterwards in March 1994. Derivatives could be introduced on regular footing only in 2000-2001 after removal of legal impediments. In the meantime, the carry forward system underwent a revision in March 1995, underwent further revision in Oct. 1997 before being banned again in July 2001. The Committee emphasise that ad-hocism should not be allowed to rule in SEBI at least in future.
148. 9.152 The Committee suggest that there should be proper risk management measures to regulate derivative trading. SEBI should also explore the desirability of introducing a formal system of exchange-operated margin trading system to bring liquidity in the stockmarket.
149. 9.158 The Committee regret to find that SEBI has not been able to arrive at any definite policy on measures concerning short sales. It had rejected initially the recommendation of its Committee on short sales in December 1996 for imposition of margins to restrict short sales. Later, reversing its own stand SEBI started prescribing margins on net outstanding sale positions from June 1998. The question of introduction of the rule of prohibition of short sales on down-tick has been under the consideration of SEBI's Committee on Short Sales since June 1998 without any final recommendation in sight even after four years. The Committee urge that SEBI must look into these issues seriously and expeditiously formulate a clear policy taking all aspects into account.
150. 9.159 There is RBI restriction on bank loans against the security of shares to Rs.20 lakh per borrower. However, it appears that no such restriction has been imposed by SEBI on stock lending by approved institutions (such as SHCIL) against the security of money deposited with them. Such
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anomalies seem to favour one section of brokers (Short Seller) and create asymmetry in the financial system. The Committee suggest SEBI to look into this issue and take appropriate corrective steps urgently.

151. 9.160 The Committee feel that in future in relation to Stock Lending Schemes, SEBI must ensure that there is proper segregation of cash and derivatives sectors.

#### RESERVE BANK OF INDIA

152. 10.8 The Committee have found both external audit and RBI supervision to have been weak and ineffective. The problems which surfaced in private setor banks like Centurion Bank, City Cooperative Bank, MMCB etc. Seem to be primarily attributable to prolonged post-inspections proceedings. These problems of individual banks could have been avoided by strict insistence on the part of RBI on the management of the banks concerned for immediate rectification of the irregularities and adherence to prudent norms.

153. 10.9 The Committee regret that they have found during the course of their examination that although the system of concurrent audit was introduced, in some banks the auditors had not been appointed for months together. The Committee stress the crucial role of ensuring concurrent audit in the regulatory functions of RBI and, therefore, recommend that this must not be relegated during the restructuring of banks. RBI must ensure adherence to its guidelines on concurrent audit.

154. 10.10 The Committee also regret that although the last JPC had recommended action against 17 auditors, little was done in this regard.

155. 10.11 The Committee regret that the said proposals were kept pending by the Central Government despite repeated attempts at all levels to get this considered. Ultimately, in October 2001 Government asked the Institute to have a re-look at the proposals. The Institute has since reviewed the recommendations afresh and would submit the same to the Government. The Committee stress that the amendments if carried out, will not only reduce the time taken in disciplinary proceedings considerably but would also ensure effective and expeditious disposal.

156. 10.14 The Committee regret that although clear guidelines were laid down about the functions of the nominee-Directors, these duties were often not taken seriously or conscientiously, as illustrated in the case of the Nedungadi Bank. This is, perhaps, because of the inherent contradictions, to which RBI has drawn the attention of the Committee, between the regulatory and participatory functions of RBI in relation to the Banks. The Committee agree with the RBI that the concept of nominee-Directors needs re-examination. The Committee conclude that the lapses on the part of the RBI nominee-Director cannot be condoned despite the opinion of the RBI to the contrary.

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157.	10.22	The Committee recommend that there must be uniformity of regulation so that the impartiality of the Regulator is recognized by all.
158.	10.31	The Committee regret that knowing fully well the ineffectiveness of the extant system in preventing the diversion of funds, RBI should not have taken before the scam broke the steps they have so assiduously put in motion after the scam. The Committee stress that a good Regulator would have anticipated the possibility of diversion of funds and taken pre-emptive action to forestall it. It is not good regulation to wait for a loophole to be exploited before closing it.
159.	10.36	The Committee recommend that RBI should constantly review the feasibility of implementing these guidelines.
160.	10.38	While the Committee commend the action taken after the scam came to light, it regrets that timely action on these matters was not taken much earlier as such pre-emptive action could have forestalled, or at least moderated, such diversion.
161.	10.43	The Committee commend these constructive steps and only regret that they were not taken earlier. The Committee recommend that RBI should constantly review the feasibility of implementing these guidelines.
162.	10.50	The Committee note that this step should have been taken earlier had the regulator been alert.
163.	10.58	These measures taken by the Reserve Bank of India will help in effectively supervising the activities of UCBs and discovering frauds if any, committed by them. It is inexplicable why these measures were not taken earlier, especially given the huge increase in the number of UCBs, the huge size of their deposits and their increasing involvement, overtly and covertly, in stock market operations well before the scam.
164.	10.72	The committee, however, deplore the tardiness exhibited in rectifying the shortcomings. Amendments to the existing legislation, submitted by RBI to Ministry of Finance on 30.10.2001, months after the scam broke, should have been proposed much earlier in the wake of the Action Taken Reports to strengthen the regulatory system. That these amendments had to wait for a second major scam to break reveal the petering out, within months of the ATRs, of the will of the Government to implement the required systemic changes.
165.	10.74	The Committee note with concern that although foreign institutional finance which started in 1992 and emerged after the mid-90s as the single largest source of funds flowing into the stock market, and thus singly contributed to the exponential increase in daily stock market turnover, neither the Regulators nor the Ministry of Finance took steps to carefully monitor and effectively regulate the flow of foreign funds into the market. Nor was this done with regard to domestic fund flows into the market.

166. 10.75 Though the Committee appreciate the steps taken by RBI from time to time, they are of the considered view that unless the regulator is ever-vigilant, rules/regulations/guidelines cannot by themselves end aberrations in financial system. As with liberty, eternal vigilance should be the watchword of the regulator. Most importantly, the legal framework must be such as to provide for strict laws which are enforced expeditiously so that a sense of fear is created in the minds of wrong-doers. Sadly, existing laws do not inculcate such a deterrent sense of fear among perpetrators of crime.
167. 10.76 Governor, RBI conceded that at present our system is “non-functional”. Yet, RBI has been rather tardy in suggesting amendments to the existing legislative provisions to make them stronger and more punitive. For instance, amendments to the Public Debt Act, 1944 in response to the 1992 recommendations of the previous JPC have been under process for seven years since 1994 and are yet to be effected. Similarly, it was not till after the present scam involving UCBs came to light that amendments were proposed to the Banking Regulation Act, 1949 to bring some of the provisions regarding cooperative banks at par with those of commercial banks. Moreover, the enhancement of the penal provisions of the Banking Regulation Act, 1949 are yet to be mooted by the RBI. Legislative amendments based on the recommendations of the Dr. L.N. Mitra Committee (2001) have also not seen the light of day so far. The Committee deplore the half hearted and casual manner in which these critical matters have been dealt with and desire that proposals already forwarded by the RBI to the Ministry of Finance be cleared expeditiously. Particularly in the present environment, when financial markets are getting integrated, it is essential that a thorough review be made of all existing laws relating to the regulatory responsibilities of RBI.
168. 10.77 The Committee find that the system of annual financial inspection has been overhauled and a system of on-site as well as off-site monitoring exists as a part of the new supervisory strategy. At present, all commercial banks are inspected at an interval of one year and in the case of Co-operative banks also the periodicity of inspections has been reduced from two years to one year. However, failure of the scale of MMCB poses a serious question on the efficacy of the supervision which is currently in place particularly in the urban co-operative banking sector. Moreover, scrutiny of inspection reports of various banks shows that while at the higher echelons of RBI, there is a paradigm shift of attention to qualitative factors, ground- level inspecting officials are still transaction based in their approach. What is required is not a proforma approach to inspections, but an approach designed to flag errors and deficiencies so as to enable qualitative appraisal to be effected at the level of each bank. Given the complexities of changes in the banking industry, the Committee feel that without a mindset change in the field level, the inspection reports would continue to be inadequate. The utility of off-site inspection reports will also not throw up significant indicators, if

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- the whole process remains mechanical. The Committee, are therefore, of the view that there is imperative need to further improve both on the on-site as well as off-site supervision so that these become more bank-specific. RBI must also identify best practices found across banks and establish uniform standards to be followed by all banks.
169. 10.78 The Committee were also informed by the RBI that it normally takes two to three months time to conduct inspections after which the inspection reports are discussed with the top functionaries of the banks as well as in the Board of Financial Supervision. Thereafter, according to RBI, action points are vigorously followed up for compliance. However, it has been noticed by the Committee that often the same type of mistakes/shortcomings get repeated year after year. This reflects adversely on the prevailing system. The Committee, therefore, feel that there is need to evolve an effective mechanism under which it must be ensured that discrepancies once pointed out are removed forthwith by the banks concerned. In case of non-compliance, individual accountability must be fixed on those who are responsible. The Committee further suggest that comments made by RBI should be published in the Annual Reports of the banks along with the financial results, to ensure greater transparency so that shareholders get a better idea about the operations of the bank. This might also induce the banks to be more compliant. There is a feeling in RBI that sudden firm and timely action against the management of the banks may lead to a run on the banks. However, the Committee are of the view that firm and timely action might forestall the possible surfacing of major failures and in some cases run on the banks.
170. 10.79 The Committee also take note that on many occasions guidelines/instructions issued by RBI which have an important bearing on the operations of the banks, are not followed scrupulously by individual banks but in most cases RBI condones such transgressions. For instance, though there is an RBI circular of 25.7.1994, Audit Committees were not constituted by the MNCB and City Co-operative Bank. In the case of MNCB, there were violations of credit exposure to single as well as group borrowers, including the group belonging to the Chairman, in violation of RBI directives on credit exposure, yet corrective actions were not effectively pursued by RBI. At the same time it has also been found that some of the guidelines issued by RBI lack clarity. This was what happened in the case of instructions issued for financing of IPOs and arbitrage. It is, therefore, essential that not only should the guidelines be unambiguous but the banks also should be mandated to follow these guidelines. The Audit Committee of the Boards should also look into the implementation of the guidelines. In case of non-compliance with the instructions, individual accountability needs to be fixed, otherwise the very purpose of issuing guidelines gets defeated.
171. 10.80 Audit is the backbone of the banking system. Whereas auditors of commercial banks are appointed by RBI, for cooperative banks, the
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auditors are appointed by the Registrar of Cooperative Societies. It has, however, been noticed that the auditors in the case of the Madhavpura Mercantile Co-operative Bank and the City Co-operative Bank have failed to discharge their responsibilities diligently resulting in a situation where there was a run on the banks and the depositors were duped. In most cases these auditors are not qualified chartered accountants, and so they fall outside the ambit of the Institute of the Chartered Accountants and no disciplinary action can be taken against them. Therefore, the RBI has now proposed to amend section 30 of the Banking Regulation Act, 1949 so that in future they are authorized to appoint the Chartered Accountants even in the case of the Co-operative banks. The Committee are, however, shocked to find that the Institute had failed to impose punishment even against a single auditor of the 17 auditors whose names had figured in the Janakiraman Committee, during the investigations of 1992 scam. It is all the more disconcerting to find that so far no concrete action has been taken to amend the Institute of Chartered Accountants of India Act, 1949 with a view to making it an effective instrument of deterrence and punishment, although a proposal in this regard is reported to have been forwarded by the Institute to the Government way back in 1994. The Committee take a serious view of such an apathetic attitude. They therefore recommend that an independent Board should be constituted under a separate statute, which should be responsible for ensuring quality in audits and also be empowered to take speedy disciplinary action against the defaulting auditors. The members of the Board should also comment on the manner in which transactions are handled, adherence to prescribed systems and procedures and whether all the risk is getting recorded and reported to the Board. Besides, RBI in their inspection reports, needs to comment on the quality of the audit carried out by the auditors and comment on the handling of the issues by the Board of Directors. In order to create a sense of responsibility amongst auditors and also to deter those who either casually/negligently or in connivance with the management hide vital information, the penal provisions in the statute should be strengthened.

172.

10.81

The Committee are given to understand that so far as the existing mechanism of vigilance in the public sector banks is concerned, the Chief Vigilance Officers are appointed from other banks/RBI etc. The Chief Vigilance Officer functions independently and reports directly to the Chief Executive of the bank under the overall control of the CVC. There is also a system of preparing a list of officials of doubtful integrity and keeping surveillance on them with a view to preventing frauds. In the case of private sector banks, including foreign banks, there is a system of vigilance which is generally with the Audit and Inspection Department. The Committee are of the considered view that any system in which the head of the vigilance cell is made to work under the control of the Chief Executive can hardly deliver the goods, more particularly when, apparently, quite a few of the irregularities committed are not only in the notice of the Chief Executive but are done at his

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instance. The 1992 JPC report had also underlined the importance of vigilance and strongly recommended the need to strengthen the vigilance machinery in the banks. The RBI in their action taken reply had mentioned that the Government had accepted the recommendations of the Ghosh Committee (1991) and accordingly instructions had been issued to the banks. Vigilance cover of the Chief Vigilance Officers had been extended over the subsidiaries also. The Committee are of the view that these measures alone are not sufficient and in order to enable the Chief Vigilance Officers to discharge their functions effectively and independently, it is also necessary that they be made accountable not to the Chief Executives but to the Committee on Audit of the Banks and through this Audit Committee to the entire Board of Directors.

173. 10.82

With the gradual liberalization of the Indian financial system and the growing integration of domestic markets with external markets, the risks associated with banks' operations have become complex and large, requiring strategic management. Events that affect one area of risk can have ramifications for a range of other areas. The Committee were given to understand that RBI issued comprehensive guidelines on 'Risk Management Systems in Banks' in October, 1999 which, coupled with guidelines on Asset-Liability Management Systems, issued in February, 1999, were intended to serve as a benchmark to the banks. Since the irregularities can be minimized if proper risk management are in place, the Committee are of the view that banks, therefore, must attach considerable importance to improving their ability to identify, measure, monitor and control all level of the various types of risks undertaken. Risks attached with assets and liabilities need to be suitably commented upon in inspection reports. The Committee regret that although the risk based approach to supervision, which is said to be an improvement over the current CAMELS approach was announced in the Monetary and Credit Policy (April 2000) two and a half years later, it still remains to be implemented. The Committee therefore recommend that RBI must ensure that same is implemented expeditiously so that the commercial banks have comprehensive risk management systems in place, including the risk-based audit system. RBI must also ensure uniform accounting practices and risk management systems in the banks. At the same time, with a view to ensuring that liquidity in the market does not get eroded, RBI must ensure that its latest guidelines issued on 11 May, 2001 are implemented. *Inter-alia*, these guidelines have asked banks to ensure that that their exposure to stockbrokers is well diversified and that the track record of stockbrokers is taken into account before sanctioning advances.

174. 10.83

Both high quality of supervision and introduction of the Risk Management Systems require up-gradation of technology in the banking system. As a part of the restructuring of the banking system, special emphasis is required to be given to effecting improvements in payment and settlement systems. There is a dire need to create a strong national

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payment system, faster computerization of branches and strengthening of the accounting system. Prominent among the measures which have also been recommended by the Committee on Technology Upgradation (1999) include introduction of Electronic Funds Transfer (EFT), Real Time Gross Settlement System (RTGS), Centralised Funds Management System (CSMS), the NDS and the Structured Financial Messaging Solution (SFMS), which will provide the backbone for all message based communication over the Indian Financial Network(INFINET). Pace of progress in these areas requires to be speeded up. The Committee feel that RBI has a long way to go in this area and desire that all efforts be made in this regard with a view to ensuring that technology gets upgraded within a stipulated time frame. This aspect needs close monitoring.

175. 10.84

The Committee in the course of their examination came across a number of cases where funds taken from the banks/Financial Institutions were not used for the purposes for which the funds were lent and had been diverted to the share market. The amount of funds which were sanctioned to different groups of companies and the details thereof have already been mentioned in detail elsewhere in the report. The Committee find that the activity of diversion of funds is not culpable either under the Banking Regulation Act or under the Indian Penal Code. The Governor RBI candidly admitted that the system as it exists today is not effective in preventing diversion of funds. The Committee were further informed that in pursuance of the recommendations of the Standing Committee on Finance, a Working Group under the Chairmanship of the IBA Chairman, Shri Kohli was constituted to look into this issue. The Group submitted its Report in November, 2001. It considered the issue and made a number of recommendations which included the definition of 'wilful default'. It also recommended punitive action for such wilful defaulters. It has also been recommended that the defaulters be debarred from institutional finance from Public Sector Commercial banks, DFIs, Government owned NBFCs, investment institutions etc. initially for a period of five years. Amongst other recommendations, the Group has also suggested that statutory amendments be initiated to empower banks and FIs to attach the assets charged to them as security directly without the intervention of the Courts of Law. With regard to filing of criminal cases against the defaulters, the Group opined that since the prime concern of the lenders was recovery of dues and filing of criminal cases against the defaulters would not necessarily lead to such recovery, for which a separate 'money suit' would also need to be filed simultaneously, causing thereby an unavoidable burden on the lending institutions, the criminal proceedings against the wilful defaulters should be initiated selectively. The Committee find that based on the recommendations of the Group RBI has already issued a circular on 30.5.2002 and the Government has also introduced a bill on 'The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest' under which the Banks and FIs have now been authorized to attach the assets charged

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to them without the intervention of the Court or Tribunal. The Committee are, however, constrained to note that even this circular is silent with respect to fixing criminal liability against those who siphon of funds deliberately, resort to mis-representation, falsification of accounts and indulge in fraudulent transactions. In view of the fact that as regards judicial interpretation of Sections 405 and 415 no offence of breach of trust or cheating is construed to have been committed in the case of loans, it is essential that such offences are clearly defined under the existing statutes governing the banks, providing for criminal action in all such cases where the borrowers divert the funds with malafide intention. Though the Committee agree that such penal provisions should be used sparingly and after due diligence and caution, at the same time it is also essential that banks closely monitor the end use of the funds and obtain certificates from the borrowers certifying that the funds have been used for the purpose for which these were obtained. Wrong certification, should attract criminal action against the borrower.

176. 10.85

Another related problem is the issue of 'financial frauds'. During the year 2000-01, RBI in its report on Trend and Progress of Banking in India (2000-01) reported 50 cases of large value frauds (Rs 1 crore and above) involving Rs. 506.34 crore. The major factors facilitating the perpetration of frauds include non-observance of laid-down systems and procedures by bank functionaries, nexus or collusion of bank staff with the borrowers/depositors, negligence on the part of the dealing officials/branch managers, failure of internal control systems, inadequate appraisal of credit proposals and ineffective supervision. During the course of the present examination, similar irregularities were noticed in the case of private as well as co-operative banks. Moreover, there is no separate Act under which scamsters can be booked and even in cases where criminal proceedings are launched cases drag on for years together in Courts, with the result that the perpetrators of frauds are seldom punished. The Committee were informed that in 1991, the Ghosh Committee was set up to enquire into various aspects relating to frauds and malpractices in banks. The Committee had made about 125 recommendations, most of which were accepted by RBI and implemented. However, with a view to examining certain legal aspects including attempting a definition of Financial Fraud and laying down procedural guidelines to deal with financial frauds, recently another Committee under the Chairmanship of Dr. L.N. Mitra was set up. The recommendations of the Mitra Committee are in two parts— Part I deals with recommendations which can be implemented without any legislative changes and are preventive in nature and Part II requires legislative changes for implementation. Some of the important recommendations contained in Part II include a separate Act to deal with financial fraud, making financial fraud a criminal offence, placing special responsibility on the regulator, setting of a separate institution for investigation, special courts for trying cross-border financial frauds as well as all offences under the proposed Financial Fraud Act. Though as

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reported by the RBI, all the recommendations under Part I have been accepted and instructions issued on 3/5/2002, the recommendations under Part II are yet to be implemented. The Committee desire that since these recommendations have an important bearing on the sound functioning of our financial system, the same should be implemented expeditiously. The Committee express regret at the tardy manner in which the issue of financial fraud has been addressed by the RBI although the Ghosh Committee (1991) and the L.N. Mitra Committee (2001) have highlighted this issue. Despite the recommendations of the L.N. Mitra Committee in September 2001, no effective mechanism has been put in place including the enactment of proposed Financial Fraud Act to deal with this problem.

177. 10.86

At present, the regulatory/supervisory framework for the Urban Co-operative Banks is the responsibility of RBI, State Governments and the Central Government (in the case of banks having multi-State presence). This results in overlapping jurisdictions and also at times in cross directives, which adversely hamper the functioning of these co-operative banks. Besides, it has also been noticed that State Registrars do not always act expeditiously on directions received from RBI, with the result that the managements of these banks are enabled to take advantage of existing loop holes to commit irregularities leading eventually to pecuniary loss to the small depositors. In the past, this issue has been considered by a number of committees, of which the Jagdish Capoor Committee and the Madhav Rao Committee are recent examples. These committees have also recommended that there is need to clearly demarcate the banking-related functions and other functions of cooperatives with a view to entrusting the regulatory responsibility separately to RBI and the Registrar of Co-operative Societies. The Madhav Rao Committee had also recommended that the only effective way of addressing the problem of dual control is to carry out amendments to the State Co-operative Societies Acts, the Multi-State Co-operative Societies Act, 1984 and the Banking Regulation Act, 1949. They have suggested different sections under the B.R.Act, 1949 which are required to be amended, including amendments to section 30 and 36AC under which RBI will have the power to appoint chartered accountants to audit the accounts and also be authorised to remove managerial and other persons from office or appoint additional directors. The Committee were informed that the issue relating to the amendments to the State Co-operative Societies Acts was recommended by RBI to the Government of India in the year 2000 with the request that the matter be taken up with the State Governments. However, the Ministry in 2001 advised RBI that it may be possible to bring co-operative banks under the discipline of RBI by making suitable amendments to the B.R.Act, 1949. Accordingly, RBI in May 2001 submitted proposed amendments to the Ministry of Finance but these proposals are still pending consideration. In the meantime, the RBI has mooted another proposal of setting up a separate apex body for regulating and

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supervising the co-operative banks, stressing that since a large number of co-operative banks are widely dispersed all over, RBI is not well-equipped to supervise them. According to RBI, this apex body should have representatives of the State Government, Central Government, RBI and other professionals. It should be an independent expert body to be able to discharge its supervisory role more effectively. The Committee appreciate the problems which emanate from duality/multiplicity of control in the case of the Urban Co-operative Banks but caution that the Government while considering the proposal of a separate apex body, should give due consideration to the problem of coordination and ensure that there is no dilution of responsibility. The proposed amendments to the relevant Acts should be carried out expeditiously so that an effective regulatory/supervisory mechanism is established without further delay.

178. 10.87 The Committee find that bank mergers is a recent phenomenon in our country and before the merger, sanction of the Reserve Bank of India is required as stipulated under section 44A of the Banking Regulation Act, 1949 and the role of the RBI is limited. No merger is allowed unless the scheme of amalgamation draft has been placed before the shareholders of the banking company and approved by a resolution passed by the majority representing two-third value of the shareholders. As such RBI does not have any role to play regarding the swap ratio arrived at and in case of any dissenting shareholder, the RBI has to determine the value of the share price which is final. This practice is at variance from that of the merger in the case of the companies, where as per the Companies Act, the approval of the court is required before the amalgamation/merger between the two companies, which also ensures fair price. The Committee therefore, recommend that RBI should discharge proactive role in laying down the guidelines to process a merger proposal in terms of the abilities of investment bankers, the key parameters that form a basis for determining swap ratios, disclosures, the stages at which Boards will get involved in order to have meaningful Board level deliberations, norms for promoter buying or selling shares directly/indirectly, during, before/after discussion period etc. Without this, many mergers will become a subject of public debate, which may not all the time necessarily be constructive.
179. 10.88 The Committee during the course of their entire examination in the present scam have found that there is no agency in our country which monitors the inflow as well as outflow of the funds, with the result that no body is in a position to say with any certainty as to how much legal or illegal money has entered the financial system and what are the various sources. In the case of OCBs for instance, there is no regulatory agency which monitors the large volume transactions. RBI also did not even inspect all the banks having large number of OCB accounts. Though the Committee were informed by the RBI, that under the RBI Act, 1934 this kind of mandate has not been bestowed upon it, they are, however, of the considered view that the RBI being the sole authority which lays down monetary policy for the country, is the only appropriate
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- agency which can be entrusted with discharging this job. They therefore, desire that Government may seriously examine this issue.
180. 10.89 With the banking sector being the mainstay of financial intermediation in emerging economies, developing a sound and healthy banking system through promotion of prudent financial practices is viewed as a *sine-qua-non* for safeguarding financial stability. In order to achieve high standards of performance, it is, therefore, imperative that the banks follow strategies and techniques which are basic to the tenets of sound corporate governance. These include capable and experienced Directors in the Board, efficient management, coherent strategy and business plan and clear lines of responsibility and accountability. While the primary responsibility for good corporate governance in the case of the banks rests with the Board of Directors, the role played by the Government, regulator, auditors and different banking associations are equally important. The Committee find that recently an Advisory Group set up under Shri M.S. Verma in its report submitted in May 2001 has made important recommendations with regard to sound corporate governance and has underlined the need to ensure that the Directors on the Boards are conversant with complex issues such as risk management, need for enhanced transparency and disclosures in respect of various aspects of boards' constitution and functioning, strengthening the Management Information System, strengthening internal control mechanisms, cross border supervision, etc. The Committee while endorsing these recommendations desire that the same be implemented expeditiously.

#### DEPARTMENT OF COMPANY AFFAIRS

181. 11.33 The Committee note that 45 out of 58 prosecutions for major offenses launched/ordered by the Department of Company Affairs (DCA) against companies involved in the present scam relate to diversion of funds. The major reason for huge transfers of money from companies to Shri Ketan Parekh is stated to be removal of restriction on inter-corporate deposits two years ago. In order to check violations in this regard, certain suggestions are under consideration by the DCA viz., putting a cap on the number of investment companies that any individual can float, prohibiting a person from being a director in more than the prescribed number of investment companies, prescribing a limit on lending/borrowing by companies, etc. The Committee hope that DCA will arrive at expeditious decisions on these suggestions and bring forth suitable amendments in the Companies Act.
182. 11.34 Section 408 of the Companies Act empowers the Central Government to appoint such number of persons on the board of a Company as directed by the Company Law Board (CLB) on a reference made by the Government to safeguard the interests of shareholders or the public interest. The Government having reason to believe that there has been mismanagement and/or oppression has decided to approach CLB to appoint Government directors in seven companies namely Padmini Technologies, DSQ Software Ltd., Kopran Ltd., Pentamedia Graphics Ltd.,

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- Panther Industrial Products Ltd., Panther Fincap and Management Services Ltd. The Committee feel that similar action should be taken on other companies which indulged in mis-management/oppression.
183. 11.35 In regard to transfer of funds by six corporate groups to Ketan Parekh, DCA has informed that six out of ten corporate groups which transferred huge amounts to entities associated with Ketan Parekh, have not violated the provisions of the Companies Act. The Committee feel that more investigation is needed on this aspect.
184. 11.36 The Committee feel that the Regional Directors and Registrar of Companies should benefit from their presence in the Governing Board of Stock Exchanges and initiate investigation when abnormal fluctuations in the price of a scrip is noticed.
185. 11.37 The Committee note that penalties prescribed in the Companies Act are nominal and the offenses are easily compoundable. For instance, violation of restriction on purchase of its own shares by a company under Section 77 of the Act attracts a maximum fine of Rs.10,000 even if funds involved are in crores of rupees. The penalties, therefore, need to be rationalised and prescribed as a percentage or multiple of the money involved in the offence. The Committee hope that the Shardul Shroff Committee which has been set up to look into the question of rationalising the penalties will give its recommendations soon and early action will be taken thereon.
186. 11.38 The regulatory powers within the Companies Act need to be strengthened to enable effective action on instances where corporate wrong doings come to light. At present, DCA has no powers even to undertake investigation. Such lacunae render the functioning of DCA ineffective and inhibit speedy action. Certain amendments listed out in para 11.16 have been proposed to enable the Department to take speedy and effective actions on violations. The proposals include vesting DCA with the power of investigation and compounding of offences, rationalisation of penalties and opening of a "Serious Fraud Office" to investigate corporate misdemeanor. The Committee urge that decision on these proposals be taken expeditiously and an amendment Bill be introduced in Parliament at the earliest. The Committee also feel that there should be a surveillance mechanism to enable *suo motu* action on erring companies.
187. 11.39 The Committee are unhappy to note that no decision was taken by the DCA on the amendments on disciplinary matters proposed by the Institute of Chartered Accountants of India (ICAI) two decades ago except for seeking a fresh set of proposals from ICAI in 1994 and again in 2001. Given this background, the Committee are not convinced of the DCA explanation attributing the lengthy disciplinary procedure followed by ICAI as the reason for the delay in taking disciplinary action against auditing entities named by the previous JPC. The Committee note that a Working Group for amending the Chartered Accountants
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- Act, 1949 has recently given its recommendations which include various suggestions on disciplinary matters, particularly, the question of fixing a time frame for proceedings in disciplinary cases. The Committee stress that as proposed by DCA, amendments to the Chartered Accountants Act should be brought before Parliament in the ensuing Session.
188. 11.40 Admittedly, the quality of inspection by the DCA leaves much to be desired. It is a matter of serious concern that the DCA Inspectors are untrained and unable to cope with the quality of inspection. The Committee hope that the weaknesses in the system of inspection will be looked into with dispatch and appropriate remedial action taken without delay in order to have an effective inspection mechanism.
189. 11.41 The Committee feel that the issue of auditor-management relationship needs to be addressed with a view to ensuring a healthy professional relationship between them. This could be achieved through rotation of auditors, restriction on non-audit fee, etc. The DCA has since appointed Naresh Chandra Committee to examine the entire gamut of issues pertaining to auditor-company relationship. The Committee urge that the Naresh Chandra Committee should complete its work within a time frame and enable expeditious action by the Government on its recommendations. The Committee feel that the desirability of having an arrangement in DCA for scrutiny of auditors' reports of all companies on regular basis needs to be examined with a view to taking suitable action on the qualifications made by auditors in their reports.
190. 11.42 The Committee note that the action by SEBI and DCA has enabled the tracing of 160 out of 229 companies which were earlier treated as vanished. There are still 69 companies which remain untraced. The Committee urge that the 'model' FIR which is at drafting stage should be finalised soon and the Central Coordination and Monitoring Committee should ensure that FIR against all the vanishing companies are registered without further loss of time and further ensure that whereabouts of the vanishing companies are ascertained. The Committee also desire that definition of vanishing companies should be made comprehensive.
191. 11.43 Apart from SEBI's action of debarring 87 companies and 336 Directors from accessing the capital market, the DCA has launched 79 prosecutions against these companies for non-compoundable offences carrying the punishment of imprisonment. What the Committee are seriously concerned is about how the investors may get their money back from the vanishing companies. The Committee urge that SEBI, DCA, Company Law Board and RBI should work seriously towards achieving this objective and take all necessary steps, including attachment of properties of directors of vanishing companies.
192. 11.44 The Committee feel that the role of companies to the extent that they impact on the Capital Market must be regulated within the Department of Company Affairs effectively and transparently. In this regard, a process of consultation must commence under the nodal Ministry.
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ACTION BY INVESTIGATIVE AGENCIES

193. 12.74 The Committee note that out of the 72 cases registered by CBI in relation to the 1992 Security Scam, 42 cases were charge sheeted, out of which only 6 cases could be disposed of and the rest are pending trial. One of the reasons contributing to this delay is that initially only one Special Court was set up and subsequently, although four more Courts were set up, but only two courts were really functional. It is really shocking that the situation remains the same even as on date. The Committee desire that this aspect needs to be taken up and resolved with a sense of urgency so as to ensure that the laws are ultimately implemented effectively and the guilty punished in an expeditious manner.
194. 12.75 In regard to 27 lakh missing shares of Harshad Mehta pertaining to 90 companies, the Committee are concerned to note that this was brought to light in the year 2000 by the custodian although all the properties, movable or immovable had been notified by the Custodian way back in the year 1992 itself. The Committee find that it is not clear as to whether the missing shares were discovered by the Custodian while taking stock of all the notified properties of Shri Harshad Mehta or it was Shri Harshad Mehta who informed the custodian about these missing shares. The Committee find that this aspect is also being investigated by the CBI. They desire that the enquiry in this regard be completed at the earliest.
195. 12.76 The Committee find that in case No. RC.3(E)/2001, which pertains to causing a wrongful loss to the tune of Rs. 137 crore to the Bank of India, CBI has filed a charge sheet in the Court of Special Judge, Mumbai on 1.6.2001 against Shri Ketan Parekh, Shri Kartik Parekh, Shri Kirti Parekh, Shri Ramesh Parekh (the then Chairman, MNCB, Ahmedabad), Shri Davendera Pandya (MD, MNCB Ahmedabad), Shri J.B. Pandya (then Branch Manager, MNCB, Mumbai). Another case No. RC 4(E)/2001 has also been registered on the orders (dated 2.5.2001), of the Hon'ble High Court of Gujarat by CBI against Shri Ramesh Parekh, Ex-Chairman, MNCB, Shri Devendera B. Pandya, MD, MNCB and Shri Jagdish Pandya, Branch Manager, MNCB Ahmedabad U/S 120-405,406,408,409,420 IPC & U/S 35(A) of the Banking Regulation Act, 1949 for conspiring together and making illegal advances to the tune of Rs. 1030.04 crores against the overall limit of Rs. 475 crores by committing breach of law and various circulars/directives/rules and regulations of RBI. The charge sheet in this case has not been filed so far. The Committee have also been informed that the Interpol reference has also been sent to Abu Dhabi for freezing the accounts of Shri Ketan Parekh maintained at Merill Lynch Bank and his alleged Swiss account is also being investigated. It has also been established that Shri Ketan Parekh had opened several accounts with the Fort Branch of GTB and carried out huge transactions with some of the OCBs having a meagre paid up capital of US \$550 to US \$5000, for pumping substantial amount of money into the stock market. The exact amount of money which has
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been used in India after having repatriated some amount to the OCBs accounts maintained outside India, particularly at Mauritius, is still being ascertained. Detailed investigation to connect funds of MMCB to the tune of Rs. 1030 crores alleged to have been defrauded is also reported to be in progress. The Committee desire that the investigations in this regard should be completed expeditiously. Since the judicial process is a long drawn process, the Committee desire that the cases which have already been filed or likely to be filed in the Courts by the CBI, should be tried by the Special Courts, so that the guilty are brought to book expeditiously. The Committee hope that the issue of setting up adequate number of Special Courts will be taken with due seriousness and with a sense of urgency by the Government, and will not meet the old fate at least this time.

196. 12.77 Economic offences wing of CBI had registered a case against Cyberspace Infosys Ltd., its Director Shri Arvind Johari, some senior officers of UTI namely Ex-Chairman Shri P.S. Subramanyam, Shri M.M. Kapur & Shri S.K. Basu, Executive Directors, and Smt. Prema Madhu Prasad, GM and some private persons and other officials of UTI on 18.7.2001, for causing wrongful loss of approximately Rs. 32.08 crores to UTI, by way of subscribing to 34,5000 shares of Cyberspace Infosys Ltd. at an exorbitant rate of Rs. 930 per share on private placement basis against the advice of their own Equity Research Cell. The Committee take serious note of the fact that although, as per the status report submitted by the CBI on 17.9.2002 the case is still under investigation and the charge sheet has yet to be filed, even when a period of more than a year has already elapsed. The Committee urge that the CBI must make an earnest effort to complete the investigation without further loss of time.
197. 12.78 In the case of City Co-operative Bank Ltd., Lucknow, CBI had registered two cases i.e. RC.19(S)/2001 and RC. 20(S)/2001. In the former case it has been alleged that Shri Anand Krishna Johari, Director, City Co-operative Bank Ltd., Lucknow entered into criminal conspiracy with Shri Gorakh Nath Srivastava, the then Secretary of the City Co-operative Bank along with Shri Arvind Mohan Johari and in pursuance thereof defrauded the Bank to the tune of approximately Rs. 29 crores by fraudulently transferring this amount to the account of the Century Consultants Ltd., in which both Shri Anand Kumar Johari and Shri Arvind Mohan Johari happened to be Directors by showing fictitious investments and bogus loans in their records and thus benefited themselves. It has also been alleged that bogus loans amounting to Rs. 817.07 crore in the name of 25 parties/persons associated with Shri A.K. Johari were sanctioned and disbursed at the City Co-operative Bank without giving any security and observing any prescribed norms. The entire amount was transferred ultimately in favour of Century Consultants Ltd. The investigation in this case is reported to be still in progress. In the second case viz. RC 20(S)/2001 the allegations are that Shri Gorakh Nath Srivastava, the then Secretary, City Co-operative Bank Ltd., Lucknow by misusing his position purchased nine cheques amounting to Rs. 1,71,35,000

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during Feb-March, 2001 issued by the group companies of Shri Anand Krishna Johari in favour of his other group companies. He did not send these cheques for clearing even after disbursement of the proceeds. When these were sent for clearing the same were returned unpaid for want of balance in the respected accounts. Investigations in this case by CBI revealed that the entire proceed of Rs. 1,71,35,000 was utilised by Shri A.K. Johari and Shri A.M. Johari for furthering their business interest. The charge sheet against Shri Gorakh Nath Srivastava, Shri Anand Krishna Johari, Shri Arvind Mohan Johari and Shri S.N. Mishra has since been filed on 13.11.2001 in the Court U/S 120-B, 420, 467 and 471 IPC. Besides, regular departmental action for major penalty has been recommended against Shri Srivastava Rao, Officer, State Bank of Hyderabad, Lucknow for his departmental misconduct. Taking into account the seriousness of the allegations, the Committee desire that investigations in case No. RC19(S)/2001 be completed as early as possible so that prosecution proceedings could be launched against the accused for having defrauded the Bank and the public at large in a dubious manner.

198. 12.79

The Committee were informed by CBI that in the case of Century Consultants Ltd. the cases were registered on the basis of the complaints received from different investors against the Company and its Directors. The main allegations pertained to duping the investors by way of floating different investment/ fixed deposit schemes by Century Consultants Ltd. and its group Companies. According to CBI, since in respect of all these cases, the accused are the same, allegations are similar in nature, *modus operandi* by the accused is also the same and the documents and witnesses are common, the investigation has been conducted jointly under case file RC 8(S)/2001. In the case of three schemes, the charge sheet has already been filed by CBI and in the case of others, the investigation is still in progress. In view of the similarity of allegations, common *modus operandi*, documents, witnesses etc., the Committee desire that in the remaining cases also the CBI should conclude the investigation speedily and take necessary follow-up action, particularly in the light of the fact that the interest of small investors is deeply involved.

199. 12.80

The Committee find that human resource constraint has been almost a perennial problem in the CBI, as during the course of the enquiry of the earlier JPC also, the same problem was spelt out. The Committee are however, concerned to note that the situation has not improved even after a lapse of almost a decade, since even at present about 50% vacancies exist in the CBI, including its Economic Offences Wing, which is a crucial arm of the investigative agency. Though it is imperative that a premier investigative agency like the CBI should not be allowed to remain incapacitated for want of both men and material, but at the same time the Committee find that basically CBI is a police organization and is not fully equipped with competent and qualified personnel for investigating into intricate financial matters. This handicap has also been expressed quite explicitly by the representatives of the CBI before the

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Committee. Taking into account, the new technological innovations where electronic modes are likely to be adopted for undertaking various types of financial transactions, it is imperative that persons investigating the economic offences are fully qualified and trained to handle the complex and diverse nature of transactions with a sense of competence and necessary acumen. The Committee find that the expert Committee on Legal Aspects on Bank Frauds set up under the Chairmanship of Dr. N.L.Mitra in their report submitted on 31.8.2001 to RBI have also, after having delved deep into the matter, observed that on account of involvement of CBI in multifarious activities, it would be prudent to have a separate multi-faculty investigative institution to deal with financial frauds. The Committee are given to understand that the Government is also seriously pondering over the issue and setting up a separate Serious Fraud Office on similar lines as in the United Kingdom (U.K.). The Committee are inclined to agree with this current thinking and recommend that a separate body be set up to investigate into all incidents of serious frauds and necessary legislation in this regard be enacted. Besides, the jurisdictional powers of such an organization should not be limited to conducting investigation against the employees of the Central Government/Public Sector Undertakings of the Government of India but should be comprehensive, covering offences committed even by the employees of the State Governments/organizations as well as those who are in the private sector.

200. 12.118 The Committee note that the investigations conducted by the Enforcement Directorate with regard to the violations of foreign exchange committed by OCBs/FIIs under the relevant provisions of FERA/FEMA, did not make much headway till the irregularities were pointed out by SEBI in their report and the report of the snap inspection was made available by the RBI. This leaves the Committee with an impression that there is no effective surveillance system existing in the Directorate under which the violations could be detected soon after the crime is committed and an immediate check imposed. The case of DSQ Software is an instant example where even when the shares were sold to a foreign company way back in May, 2000, without the express permission of the RBI, the investigations were started only in August, 2001. In fact the Directorate geared itself up only at the instance of the JPC and ultimately launched prosecution against the Company on 30th May, 2002 *i.e.* the penultimate day when the sunset clause of FERA, 1973 was to come to an end.
201. 12.119 The Committee note that the investigations taken up by the Directorate are confined mostly to such cases where either the complaints are received or where the irregularities get pointed out by some organizations. The Committee are however of the considered view that in a highly liberalized and free market economy of today, where e-commerce, mergers and joint ventures are taking place at a pace which had not been witnessed before, it is essential that the Directorate also revamps itself in consonance with the emerging demands by

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- imparting suitable training to the staff not only in corporate laws but also in cyberspace and computerization. Besides, it needs also to strengthen its intelligence/surveillance department so that it becomes a vibrant and effective instrument.
202. 12.120 The Committee find that OCB route has been used by some of the broking entities in manipulating the market in the present scam. Investigations conducted by the Directorate revealed that certain OCBs committed a number of violations under FERA, 1973 as well as FEMA, 1999. It is however, surprising that these OCBs were not regulated by any of the regulators and even the violations committed by them both under FERA/FEMA had gone un-noticed even by the Directorate of Enforcement till these were pointed out by SEBI in their Interim Reports. Some of these irregularities include sale and purchase of shares without actual deliveries, purchase of shares on adjustment basis without fund flows from their accounts to the accounts of the brokers, booking of purchase orders without sufficient balances in their accounts, exceeding 5% ceiling as prescribed for individual OCBs and violations of 10% aggregate ceiling norms, etc. These OCBs include M/s Brentfield Holdings Ltd, M/s Wakefield Holdings Ltd, M/s Kensington Investments Ltd., M/s Far East Investment Corporation Ltd. and M/s European Investments Ltd. The Committee are given to understand that except M/s Brentfield Holdings Ltd. which has been issued show cause notice under FERA 1973, in the case of others, final complaints have already been filed under the relevant provisions of FEMA 1999 before the Special Director of Enforcement for adjudication. Besides, 16 FIs and their sub-accounts have been charged under section 29(1)(b) of FERA, 1973 relating to the purchase of 5,92,950 shares of HFCL from First Global Stock Broking Pvt. Ltd. without specific approval of RBI. FIs and their sub-accounts have also been charged under section 29(1)(b) read with section 64(2) of FERA, 1973 for attempted purchase of 2,37,600 shares of HFCL from First Global Stock Broking Pvt. Ltd. without specific approval of RBI. The Committee desire that all these cases should be decided expeditiously.
203. 12.121 The Committee note that the investigations against ZEE Telefilms have been inconclusive so far, as the Directorate has not yet found any FERA/FEMA violations by the company. The Committee desire that the investigations should be pursued further with a view to ascertaining if at all any violations were committed.
204. 12.199 CBDT's role is mainly confined to follow up actions after a scam. If those actions are swift the right message will go to the Stock Market. The Committee note that even after an expiry of almost a decade, the culprits of the 1992 Scam, have not been punished and the cases are still pending adjudication in the Special Courts. The only penalty so far imposed is the monetary one which is reported to be to the tune of Rs.700 crore, and that too has been imposed only on a single Group. Not a single case of Harshad Mehta Group has been finalized and although the assessments in the case of the other group viz. Bhupen
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- Dalal Group have been finalized, no criminal proceedings have been launched against the Group. It is equally serious that against the total outstanding demand of Rs. 11,323 crore, an amount of only Rs. 2203.70 crore, including Rs. 165.70 crore in the case of Fair Growth Financial Services Ltd, has been confirmed, since a large number of cases are reported to be still pending with CIT(Appeals). Only a paltry sum of Rs. 292 crore has so far been recovered. The property worth Rs. 3106.80 crore which stands attached and which includes mostly shares has also not been disposed of despite the fact that a scheme in this respect stands approved by the Special Court as far back as in September, 2000 and a Disposal Committee headed by the custodian for its proper implementation, was also constituted.
205. 12.200 Though the Department of Income Tax while putting forth defence for this tardy progress has blamed the brokers for not finalizing their accounts and getting them audited by the auditors, the fact that the Department also did little in making concerted efforts towards progressing the case can hardly be ignored. It is amply clear that before 1998 no serious effort was made by the Department in this direction. It is all the more disheartening to find that only two Courts are functional. The Committee are of the considered view that unless the guilty are brought to book expeditiously, nothing is going to deter the perpetrators of crime or inculcate a sense of confidence among the investors. It is therefore essential that the assessment orders are finalized, demand raised, pending appeals decided and those who did not deliberately disclose the income, be prosecuted without further delay. Besides, it is equally essential that more Special Courts be made operational so that the long pending cases can be disposed of speedily. This chapter finds place in the report specifically to emphasize the importance of speedy justice.
206. 12.201 The Committee note that the JPC investigating the security scam of 1992 had recommended that a Special Cell may be constituted to investigate the role of big industrial houses and to expose the nexus between banks, brokers and promoters in engineering the 1991-92 securities scam. The Cell which was constituted thereafter in June, 1994, headed by DGIT (Inv.), Bombay virtually stopped functioning after having five meetings, the last being in May, 1995. The Committee are concerned to find that the Cell went into hibernation in the last six years and what is more intriguing is that it met only on 31.7.2001, when the matter came up before the present Joint Parliamentary Committee. The Committee express their displeasure at the way the Special Cell functioned. They recommend that responsibility for this laxity should be probed.
207. 12.202 The Committee note that a Convention for the avoidance of double taxation and fiscal evasion with respect to taxes of income and capital gains was entered into between the Government of India and the Government of Mauritius and notified on 6.12.1983. Its main object was
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to give encouragement to mutual trade and investment. The convention applies to persons who are residents of one or both of the contracting States. As per Article 2 of the Convention, the taxes to which it applies in the case of India are the income tax including any surtax imposed under the Income tax Act, 1961 and the surtax imposed under the Companies (Profits) Surtax Act, 1964. In the case of Mauritius, the convention applies to 'Income Tax'. The Article further stipulates that the Convention also applies, in addition, to any identical or substantially similar taxes which are imposed by either contracting State. Article 13 gives the right of taxation of capital gains only to that State of which the person deriving the capital gains is the resident. Under Article 4, the term 'residence' has been defined, as any person who under the laws of that State is liable to taxation by reason of his domicile, residence, place of management or any other criterion of similar nature. Mauritius, however, has no capital gains tax imposed under its law.

208. 12.203

The Committee note that the year 1992 was marked by two significant developments both in Mauritius and India. One was the enactment of Mauritius Offshore Business Activities Act (MOBAA) by Mauritius and the other was the opening up of Indian economy inviting Foreign Institutional Investors (FIIs) to invest in the Indian Capital Market. It was primarily with an object of regulating offshore business activities from within Mauritius that MOBAA was enacted and after this, the 'residence' clause acquired greater meaning since the nature of residence changed in Mauritius. The Committee note that it was after the enactment of MOBAA that significant inflow of funds was started by the Off-shore companies situated outside India who in order to save capital gains tax and taking advantage of the 'residence' clause opened subsidiaries in Mauritius and started investing in India through the Mauritius route even when the main business activities were confined to a third country outside Mauritius.

209. 12.204

From the evidence placed before the Committee it becomes amply clear that some of these companies were having only negligible paid up capital and these were in fact post-box companies. Some of the Indian corporate Groups also took the overseas corporate route and set up subsidiaries in Mauritius. The fact of the possible revenue loss incurred on account of offshore companies using the Mauritius route by claiming residence in Mauritius and not paying capital gains tax in India, was realized way back in 1993, when the issue was raised by the Department of Revenue. However, the efforts to re-negotiate the treaty could not make much headway as the entire Mauritius financial offshore sector was based on India related business and any move to change the Treaty provisions would have resulted in diversification of these funds to other markets. Since then the Committee find that sustained efforts were made by the Government of India including the constitution of a Joint Working Group in 1996 and the matter was taken at the highest level in order to express the concerns relating to misuse of the provisions

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		of the Treaty but due to the special relationship which India enjoys with Mauritius and due to very close political and strategic partnership and also in view of the fact that India has entered into similar treaties with a number of other countries, and Mauritius alone could not be singled out for that matter, the provisions could not be reviewed.
210.	12.205	The Committee find that though the exact amount of revenue loss due to the 'residency clause' of the treaty cannot be quantified, but taking into account the huge inflows/outflows, it could be assumed to be substantial. They therefore recommend that Companies investing in India through Mauritius, should be required to file details of ownership with RBI and declare that all the Directors and effective management is in Mauritius. The Committee suggest that all the contentious issues should be resolved by the Government with the Government of Mauritius urgently through dialogue.
<b>MINISTRY OF FINANCE</b>		
211.	13.3	The Committee are agreed that ministerial responsibility in regard to this Report flows from these principles.
212.	13.20	It is thus observed that the Ministry of Finance have been repeatedly emphasizing the need for expeditious corrective measures for effective regulation and controlling the high degree of volatility in stock market. Actions taken by Ministry of Finance and SEBI to warn investors during the rise of stock prices have been noted by the Committee. It has also been noted by the Committee that there was a feel good factor and feeling that India had arrived on the IT scene. Although actions have been taken by the Ministry of Finance and SEBI during the period when the stock market was rising unusually, the Committee are of the considered view that both these should have been more proactive and vigilant.
213.	13.23	The Committee underline the necessity for early implementation of corporatisation/demutualisation of Stock Exchanges process.
214.	13.31	A number of legislative proposals have been initiated by RBI and have been discussed in detail under the chapter "Reserve Bank of India" of this report. The Committee are constrained to observe that there have been serious delays at both the regulators' end and in the Ministry of Finance and other Ministries concerned in processing legislative proposals for strengthening the regulators and endowing them with more punitive powers. The Committee deplore the delays in Government in processing the legislative changes proposed by the RBI with the dispatch that they deserve.
215.	13.38	A perusal of the working of the HLCC indicates that this Committee concerned itself with the co-ordination aspects only. The Committee did not go into the general situation of the economy or the stock market and did not make any recommendations excepting those that

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- related to actions to coordinate activities of various regulators like RBI, SEBI, DCA etc.
216. 13.45 The Ministry of Finance is the nodal authority and co-ordinates the functions of all the departments/organisations working under its administrative control. Regulators are accountable to the Ministry of Finance which, in turn, is responsible to Parliament. All the policy making powers also vest with the Ministry. SEBI, as the independent statutory Regulator, has been endowed with powers to autonomously regulate capital markets. According to the Ministry, the general approach of the Government has been to instil professionalism by having the people who are knowledgeable in their respective fields. The Committee find that SEBI which was set up as a statutory body through an Act of Parliament in 1992 was hitherto being managed at the senior level not by the professionals but by the persons taken mostly from the Income Tax Department/Indian Administrative Service on deputation basis. Besides, as per the provisions of SEBI Act, 1992, the SEBI Board consists of 5 members besides the Chairman. The Board is largely dominated by the Government nominees as the Chairman and 2 members are nominated by the Central Government from amongst the officials of Ministry of Finance and Ministry of Law, while one member is nominated by the RBI. The Ministry of Finance have made legislative changes for amending the SEBI Act through an Ordinance in order to give it more teeth for regulating and development of capital market. The Committee are of the view that in order to give true autonomy to the market regulator, there should be complete transparency in the appointment of the Chairman and the members of the Board. In this regard, the Committee agree with the suggestion of the former Secretary of the Department of Economic Affairs that for appointment to the top positions in such organizations including the banks, there should be a Search Committee, whose recommendations should be final and mandatory. In order to give such body a legal sanctity, it is essential that its constitution is well defined and provided under the relevant statute. The Committee therefore, recommend that while amending the SEBI Act, this aspect should also be given serious consideration.
217. 13.46 While accepting that managerial and functional accountability is required to be vested in statutory independent Regulators so that they can perform their functions effectively and without undue interference, the Committee stress that accountability must go hand-in-hand with autonomy and the principles governing the responsibility of the Minister to Parliament in terms of the constitutional jurisprudence under which the parliamentary system works. The Ministry should also evolve appropriate checks and balances to overcome the systematic shortcomings in the present system which has resulted in this scam. The Committee feel that the approach of the Ministry of Finance should be to progressively make SEBI a very effective and efficient regulator of capital market which can inspire confidence amongst various players. The Committee note that recent legislation has now endowed SEBI with
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- the required powers to moderate stock market volatility and inspire investor confidence.
218. 13.47 The Committee recall that the 1992 JPC had drawn attention in paragraph 2.8 of its Report to the "very damaging approach (which) seems to pervade, that of transferring responsibility downwards. This distressing lack of fibre in the apparatus of governance can only debilitate the state." Regrettably, notwithstanding the passage of nearly a decade since that Report, nothing seems to have changed. The culture of governance continues to be pervaded by attempts at transferring responsibility elsewhere. Therefore, the Committee recommend that there must be a clear demarcation of responsibilities between the Regulators and the executive so that there is transparency in the system of accountability.
219. 13.48 The Ministry of Finance, being the financial custodian of the country, is duty bound to protect the interests of the small investors. SEBI has now been endowed with statutory powers under the amended SEBI Act to secure redressal of investor grievances and entitle investors to seek compensation, the award of damages etc. Besides this, Professor L.N. Mitra in his report to SEBI on this issue has also suggested for a separate Act for investors protection, as detailed in Chapter XIV of this Report. The Committee recommend expeditious action on this proposal. Further, in order to deal with vanishing companies and collective investment schemes, SEBI has suggested that Securities Appellate Tribunal (SAT) be empowered to attach properties of such defaulters. The Government has reconstituted the SAT to be a multi-member body which should help in expeditious disposal of cases.
220. 13.49 Regarding demutualisation and corporatisation of the stock exchanges, the SEBI constituted a Committee under the Chairmanship of Justice Kania to provide definite road map for the early completion of the process, which has since submitted its Report. The Committee recommend that the Government must ensure expeditious implementation of the demutualisation and corporatisation process so as to improve management of the exchanges and enabling smooth conduct of business in a fair and non-partisan manner.
221. 13.50 It is imperative that the question of coordination between various Regulators among themselves and with the Government be seriously addressed to by the Ministry of Finance. The Government in their revised Action Taken Report on the implementation of recommendations of the earlier JPC on Securities Scam which was tabled in Parliament in December 1994 had *inter alia* submitted that the HLCC constituted by the Ministry of Finance in May 1992 had been set up for ensuring greater co-ordination among the regulatory agencies in the financial and capital markets and meet regularly to review the position regarding financial/capital markets. The Committee note that HLCC has not carried out the latter portion of their mandate *viz.* "regularly review the position regarding financial/capital market." The Committee consider this an
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unfortunate omission. The Ministry of Finance on its part and in relation to the assurance given by it to the Parliament in its revised ATR has not referred such crucial issues to the HLCC which was supposed to review the position regarding financial/capital markets. Had these issues been taken up by the HLCC periodically, it would have definitely helped in minimizing, if not preventing altogether the irregularities which have surfaced in the present scam.

222. 13.51 Although there is need for better and closer coordination amongst the multiple agencies which are actively involved in our financial system, the Committee are of the considered view that a super regulator is not the answer to the problem. This task can be handled by HLCC and to this end HLCC should be serviced by an efficient secretariat. In addition to its present functions, HLCC should also be mandated to ensure the expeditious implementation of ATRs arising out of JPC recommendations. The Committee also stress the importance of elaborating and detailing the functions of HLCC with regard to undertaking "regular review of position regarding the financial/capital market."
223. 13.52 The Committee note that while the Banking Division monitors the overall functioning of public sector banks and rural cooperative banking system in the country besides reviewing circulars/instructions issued by RBI, it is not concerned with individual operations of the banks as the same are carried out in accordance with the guidelines of the RBI. As per the provisions of the RBI Act, the general superintendence and direction of the affairs of the Banks has been entrusted to the Central Board of Directors of RBI on which the Government has a nominee (generally Finance Secretary). Further, before taking a decision in a matter of larger public interest, RBI consults the Government. However, the Banking Division is responsible for legislative framework relating to the Banking Sector which includes RBI Act, 1934, Banking Regulation Act, 1949, SBI Act, 1955, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, Regional Rural Banks Act, 1976, Public Debt Act, 1944 etc. The Committee however note that a large number of legislative proposals with respect to the Commercial and urban co-operative banks mooted by the RBI are pending consideration in the Ministry. The details of the proposals have already been mentioned in the Chapter on the Reserve Bank of India of this report. The Committee recommend that the Ministry should expeditiously finalise the proposed amendments in the Banking Regulation Act, 1949 and introduce the amended legislation in the Parliament at the earliest.
224. 13.53 The Committee express their concern at the inordinate delay of almost 8 years by the Government in implementing the recommendations of the earlier JPC of 1992 on Securities Scam regarding the framing of statutory provisions with regard to making the bouncing of SGL transfer forms as penal offence as in the case of cheques. Although the said recommendation was accepted by the Government way back in 1994, but so far the Government Securities Bill, in which the statutory provision

is proposed to be incorporated is yet to be enacted and the Bill is expected to be introduced in Parliament only during the Winter Session of 2002. As the matter has already been inordinately delayed, the Committee recommend that the Government should expeditiously repeal the Public Debt Act, 1944 and enact the new legislation without further loss of time.

225. 13.54 To contextualise the period in which the present scam surfaced, resulting ultimately in the crash of the stock market from March 2001 onwards, the Committee reviewed the implementation of the recommendations of the 1992-93 Joint Parliamentary Committee which had enquired into irregularities in securities and banking transactions and found a number of areas in which the recommendations had not been taken seriously. The process of economic liberalization *vis-a-vis* banking transactions and innovative portfolio management schemes had started almost concurrently with the proceedings of the earlier JPC. Although through the 1982 Budget Speech of the then Finance Minister, OCBs had been given the same status as NRIs and PIOs and allowed to invest in India, and in 1992 through the Budget Speech of the then Finance Minister, FIs were allowed to enter the Indian capital market. Modifications in the regulations relating to OCBs since 1982 and FIs between 1992 and 1999 have not put sufficient risk-hedging regulatory measures in place. Therefore, systemic deficiencies caused by insufficient risk-hedging regulatory measures opened windows of opportunity for brokers, ALBM/BLESS/MCFS players, OCBs/FIs etc. Therefore, it is these regulatory lapses which were part of the problem and need focused attention.
226. 13.55 According to the Banking Division, based on the recommendations of the earlier JPC on Securities Scam, a number of measures have been taken by the Government and the RBI to address systematic deficiencies which contributed to the irregularities. However, the steps taken thus far have not forestalled irregularities which have led to large amounts of money being pumped into the stock market and its consequent misuse by certain entities, as detailed in this Report.
227. 13.56 As discussed elsewhere in this report, the Committee are concerned to note that there has been no regulatory framework to monitor the activities of OCBs as these are neither registered nor regulated by SEBI and also are not under the regulatory framework of RBI. The Ministry of Finance being the main policy making body, has not applied their mind in this regard. The Committee note that this issue has currently been addressed by banning OCBs from making any fresh portfolio investment in the securities markets. The Committee are of the view that this may not be a permanent solution and recommend that the Ministry of Finance needs to lay down clear policy guidelines for monitoring the operations of OCBs.

#### INVESTORS PROTECTION

228. 14.52 Investor protection is a continuous exercise and not a one-time effort. A recent survey done by National Council of Applied Economic Research

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for SEBI reveals that only a nominal portion of household savings flow into the capital market. The main reason for such insignificant flow can be attributed to lack of confidence of the retail investors in the capital market. It has been observed that poor disclosures at the time of public issue and manipulative pricing of the 'issues' by the companies often results in robbing the uninformed investor. In order, therefore, to ensure that the investors are well informed, it is not only very important to have full disclosures but also to ensure that these are authentic. The Committee recommend that the Managing Director/Chief Executive Officer and one Director of the Company at least, must certify all disclosures made by the listed companies to be true and correct and in case the same are found to be false, these officials must attract criminal liability under the law.

229. 14.53 The Committee are also given to understand that the prospectus is not vetted by SEBI, with the result that promoters are able to bring public issues at highly manipulative prices. It is therefore imperative that SEBI should formulate suitable guidelines for evaluating the prospectus and in case of dubious or fraudulent promoters, it must stop the public issue. As regards IPOs (Initial Public Offering), two vital issues-pricing and tracking the end use of funds have been totally neglected by SEBI. While determining pricing is a difficult task, there can be differences of opinion about the price genuinely, but to leave this entirely to the discretion of management based on the recommendations of the merchant bankers, does not serve the interests of small investors. The very fact that during the mid-nineties, in many cases, dishonest management of the companies cheated the poor investors of thousands of crores by bringing out highly overpriced issues and SEBI did not react, on the plea that in the free market regulator need not interfere, is not acceptable to the Committee. Totally free market pricing in a market which is highly imperfect and has a long history of fraud and manipulation is not a workable solution. Fair pricing through the book building rules has also failed to achieve the desired results. It is, therefore, suggested that SEBI should either use industry benchmarks or evolve other suitable criteria for this purpose. SEBI and DCA have been quibbling for the past many years, each one saying that to determine the end use of the funds raised through IPO was not its responsibility, with the result that manipulative promoters have had full liberty in diverting the funds. The Committee are of the view that this responsibility must be discharged by SEBI and the management of defaulting companies should be suitably punished.
230. 14.54 The Committee feel that award of compensation to aggrieved investors is an area which requires urgent attention. The Committee in this connection note that Dr.N.L. Mitra in his study on investors' protection has suggested that Consumers' Court or Securities Tribunal should be empowered to award compensation to aggrieved investors. He has also suggested a separate Act for protecting investors' interest. The Committee feel that implementation of these suggestions will go a long

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- way in protecting the investors' interest and accordingly recommend expeditious consideration of these suggestions for implementation.
231. 14.55 An Investors Association has made a plea for banning preferential allotment of shares, except for foreign collaboration, on the ground of being inherently anti-investor and being a powerful tool to manipulate market prices of shares. The Committee note that SEBI has since decided to bring preferential allotment of shares under the take-over code and will subject it to stringent discipline. This step should not eliminate preferential allotment of shares to legitimate purposes like giving equity stake to a technical collaborator but should be strictly watched to prevent misuse. The Committee hope that the Department of Company Affairs, as proposed, would expeditiously frame rules governing preferential allotment of shares under Section 81 of the Companies Act in consultation with SEBI.
232. 14.56 It transpired during evidence that the Chairman of the Take over Committee appointed by SEBI, during his Chairmanship, had given legal advice in his private capacity in regard to take over by companies. Such acts appear inappropriate.
233. 14.57 A number of suggestions has been made to protect the investor's interest and to restore the confidence of investors in the stock market as contained in paragraphs 14.29 and 14.31. Some of these have been recommended in this report under the Section "Powers of SEBI" which include the suggestions regarding power of investigation, power to impound/retain documents, attachment of the properties of defaulting Promoters/Directors/Companies, enhancement of monetary penalty, power to disgorge ill-gotten profits and power to impound ill-gotten money. The Committee particularly agree with the suggestions viz., distribution of impounded funds amongst the affected investors, making manipulation of shares a cognizable offence, mandatory disclosure by promoters of their intention to increase or decrease their share holdings and the need to define "undesirable activities" and accordingly recommend that appropriate action be taken in this regard. The Committee is inclined to agree to giving representation to investors on Boards of listed companies, on SEBI, and on various Advisory Committees, and recommend that this aspect be examined for suitable action. The Committee hope that suggestions for encouragement and suitable funding of investors associations will receive consideration in order to ensure their active participation in matters relating to investors protection.
234. 14.58 Investor education plays a vital role in enabling investors to take informed decisions and to ensure that their interests are protected. It appears that not much has been done in this area by SEBI except issuing some advertisements, circulation of a booklet and funding of seminars by Investor Associations. At present SEBI, DCA and RBI have their parallel independent investor awareness campaigns. The Committee feel that coordinated and organized efforts are needed to educate investors
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- about their rights and responsibilities and to impart awareness about common pitfalls and mistakes that lead to investor losses and SEBI should be vested with this responsibility. Further, the Committee feel that to enable SEBI to undertake this task effectively, the Investor Education and Protection Fund established under Section 205 (c) of the Companies Act and Investors Education Resources of RBI should be shifted to SEBI and a joint campaign under the leadership of SEBI be undertaken. The Committee also recommend that unclaimed/undistributed funds such as dividend, principal amount, interest, debenture amount and fixed deposits of any nature and instrument with limited companies, cooperative banks, banks mutual funds and insurance companies should be transferred to this Investor Education and Protection Fund.
235. 14.59 The other important issue, which has been neglected by SEBI, pertains to resolution of investor complaints, whether against companies or other stock market intermediaries. Though the cumulative redressal rate of investor grievances against companies presented in SEBI's annual report has been above 90% during the last four years, the feed back received by SEBI from the investors indicates a redressal rate of just 41 to 43 per cent in the years 1999-2000 and 2000-01. Liquidity is the essence of capital market and delay in redressal of the investor complaints militates against the liquidity. The Committee suggest that SEBI should examine the reasons for sluggishness in resolving investor complaints and must ensure that all investor complaints against the companies are resolved within 30 days. Failure in this regard requires to be punished with heavy financial penalties which both the Stock Exchanges and SEBI must be empowered to impose. Further, along with the public disclosure of quarterly financial results, companies must be directed to publish the number of investor complaints received, disposed off and lying unresolved at the end of each quarter. Such public disclosure will go a long way in pressurizing the companies to act with speed.
236. 14.60 There also appears to be a need to have an independent look at resolution of investor complaints against companies and market intermediaries. The Committee recommend that the concept of Ombudsman, which is already being used in the banking sector, should also be extended to the capital market. The issue of power, duties and responsibilities of the Ombudsman should be suitably worked out. As regards investor complaints against Brokers and other market intermediaries, arbitration councils at exchange level can be used for resolution of investor complaints. Such bodies would be independent of market intermediaries, particularly the brokers. The Committee are of the opinion that ultimately Special Courts dealing exclusively with the investor complaints of the financial sector would be a real solution to the expeditious disposal of complaints. Such courts could have jurisdiction for all kinds of financial irregularities, frauds in the case of the capital market, chit funds, NBFCs, plantation companies. Etc.
237. 14.61 The Committee also recommend that a Committee consisting of representatives of SEBI, DCA, RBI (NBFC and Banking Division), Stock
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		Exchanges, Investors Associations should be set up to develop an effective investor grievances redressal system.
238.	14.62	SEBI need to act as the nodal agency to receive complaints of investors, transmit them to agencies concerned and follow them up for speedy action. An independent audit on redressal of investors' complaints by the regulators should be conducted periodically.
239.	14.63	The Committee learn that compensation payable from the Stock Exchange Investors' Protection Fund on account of defaults of brokers involve several months or even years to resolve although it is required to be resolved within 90 days. The Committee feel that the operation of the Investors' Protection Fund in Stock Exchanges needs to be streamlined.
240.	14.64	The Committee note that at present insurance coverage from the Deposit Insurance and Credit Guarantee Corporation (DICGC) is available to depositors in Co-operative Banks. The Committee suggest that the feasibility of extending a similar scheme to depositors in NBFCs may be examined. The amount of insurance coverage which stands at Rs. 1 lakh at present also needs to be raised at least to the level of Rs. 2 lakh.
241.	14.65	A scrutiny of complaints handled by the Stock Exchanges viz., BSE and NSE reveals that the number of complaints against companies has been very much higher than against members of the exchanges. For instance, in the year 2000-01, complaints received by BSE against companies stood at 37,461 and those against members at 779. In NSE, the corresponding figures were 1,095 and 263. The same is true of the previous years. The Committee suggest that companies including "Z" category companies of BSE, which are deficient in their services to investors should be identified and strict action taken against them. Companies that deliberately ignore investor complaints need to be severely punished. The Committee recommend that legislative lacunae, if any, in implementing these suggestions should be removed.

## PART-II

### UNIT TRUST OF INDIA

#### OVERVIEW

242.	15.9	It is the view of the Committee, as detailed in the subsequent chapters, that the crisis faced by UTI reflects the decline of a public institution on account of its failure to change itself to face competition and regulation since the opening up of the country's financial markets in 1993. The present state of affairs in UTI is a consequence of the negligence of its principal contributor, IDBI (which is also a public sector institution), the concentration of power in the post of the Chairman, UTI without adequate checks and balances to prevent its misuse, and the
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unwillingness of the UTI management and the government to make the necessary legislative and organizational changes to restructure the institution and bring it under the purview of the market regulator. Moreover, investment decisions in UTI were not always prudent or in accord with the interests of the investors. UTI's competitive environment was constantly changing and 1993 onwards successive governments very well realised that UTI had to be revamped to keep pace with change but did not take effective measures on this front, as they did not wish to lose control over it. A combination of lack of urgency in successive governments, abetted by self serving and negligent management in UTI and inertia in the Ministry of Finance undermined a public financial institution by directing its investment and lending decisions in favour of dubious private sector promoters in the name of reviving the capital markets, ignoring the fact that the purpose of UTI was to serve the interest of unit holders, specifically individual unit holders of small means. The UTI episode also focuses the need for improving the system by which statutory institutions can be made more accountable to Parliament and the public to ensure transparency in their functioning.

#### INVESTMENT POLICY AND DECISIONS

243. 16.5 The Committee are astonished to find that statutory auditors are not required to comment on the quality of investment decisions and that these decisions are also not subject to any subsequent scrutiny. The Committee urge that this be done forthwith.
244. 16.8 The Committee feel that the decentralization process was not fully implemented.
245. 16.12 The Committee deplore the extent of discretion vested in the Chairman and the EC in making the levels of investments especially in IPOs and private placements in debt and equities. This was all the more deplorable when such investments were not subject to scrutiny, resulting in complete lack of transparency and accountability. The recommendations of the Standing Committee on Finance that such discretionary powers may lead to undesirable and unhealthy practices coupled with the fact that the Ministry of Finance was aware of the extent of authority and its exercise, should have persuaded the Government to intervene in the affairs of UTI keeping in mind the public interest, especially the interest of the ordinary unit holders whose small investments were thus put in jeopardy.

The Committee also conclude that the reduction of NPA's reported by UTI were mostly a result of accounting adjustments rather than the actual recovery of dues. Under the provisions of section 19B of the UTI Act, UTI can apply to a court for attaching the assets or transferring the management of a company, which has defaulted in its repayment to UTI. The Committee note that UTI has not invoked this section even once since 1992 though 92 cases before debt-recovery tribunals and 24

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- before High Courts for recovery of debts from defaulting companies have been filed under the general provisions as on 30.6.2002. The Committee recommend that UTI should focus on recovering its debts from defaulting companies.
246. 16.14 While UTI dragged its feet in implementing necessary organizational changes, the Ministry of Finance should have been proactive in bringing in the required legislative changes and bringing home to UTI through its frequent interaction with UTI the need for a radical overhaul in UTI's investment policies and decision-making mechanisms. The need for this had been apparent for a decade, especially after the receipt of the 1993 Vaghul Committee report and was further underlined by the Deepak Parekh Committee six years later.
247. 16.21 The Committee note that the UTI management sanctioned inter-scheme transfers to boost the income and liquidity of some schemes, that these decisions were not taken by individual fund managers but by the Chairman and Executive Directors and that brokerage was paid on these transfers in violation of UTI's own guidelines. The Committee find Sh. Subramanyam's explanations regarding these transactions unacceptable and since these decisions were taken and ratified by him, he must be dealt with in accordance with law. The Committee also recommend that UTI take action against other officials who were party to sanctioning inter-scheme transfers in violation of the policy guidelines regarding inter-scheme transfers laid down by the Board of Trustees.
248. 16.28 The Committee recommend that UTI should conduct a review of instances of investments going into default within a short period of their sanction indicating possible deficiencies in the investment decision-making process, Investments and Fresh Exposures in companies classified as NPAs, Investments made in one company of the group while there was already a default in another company of the same group, payment of brokerage on inter-scheme transactions and applications for acquisition of shares at rates higher than the prevailing market rate as identified by the Tarapore Committee. As a part of this review, it should isolate instances where there has been a violation of administrative procedures or due diligence and conduct time bound departmental enquiries in such cases. The Committee also recommend that UTI formalize a comprehensive investment policy.
249. 16.29 Based on their examination of written and oral evidence of the off market investment in the shares of DSQ Software and Numero Uno International, the Committee agree that both decisions were detrimental to the interests of UTI and its investors.
250. 16.31 Though the ERC was set up in 1997, it is only during Shri Subramanyam's tenure from September 1998 that onwards the ERC's comments were overlooked. This is further compounded by the fact that in all these cases UTI's investment portfolio depreciated after the investment. In the
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specific case of Cyberspace Infosys, the ERC's comments were first accepted and subsequently reversed to clear the investment. Worse, there are cases (one of which, Numero Uno International, has been examined by Tarapore Committee in detail) in which the ERC's recommendations were not taken at all. In the light of this, the explanation of Sh. Subramanyam is not convincing. All this clearly indicates that the decisions to bypass the ERC's recommendations were not in the interest of UTI. Given the fact that in all these cases, UTI's investments have recorded a decline, the decisions were *prima facie* wrong and possibly malafide. The Committee recommend that UTI conduct a departmental vigilance enquiry regarding the decisions where the ERC's views have not been taken or the ERC's views have been overruled to ascertain whether the decisions were taken after following proper procedures or were arbitrarily made without due diligence. The Committee recommend suitable action against officials who are found to be involved in arbitrary decision making. The Committee also recommend that the delegation of authority to make investment decisions in UTI should be decentralised and a comprehensive investment policy should be formalised.

251. 16.37

The lack of a proper risk management system in secondary market operations, the absence of any laid down guidelines for dealer authority and stop-loss limits to liquidate loss making positions, the absence of any documentation of the rationale for secondary market transactions in particular shares, the concentration of power for both fund management as well as dealing room operations in one person and the lack of any security system to preserve the confidentiality of the dealing room's voice recording mechanism lead the Committee to conclude that the absence of laid down procedures for secondary market transactions allowed the UTI management to purchase and sell any quantity of any share in the secondary market without any accountability. The Committee recommend a thorough enquiry of the secondary market transactions in the shares of the 89 companies identified by the Tarapore Committee. This enquiry may be conducted by SEBI for the period 1992-1993 to 2000-2001 by looking at these transactions at the level of UTI's dealing room and at the level of individual brokers and responsibility be fixed for any incidents of broker-UTI dealer nexus, front running, benchmarking, etc. As the lack of any documentation of secondary market transactions will make an audit trail difficult, the Committee desire that SEBI devise suitable mechanisms for identifying wrongdoing. Steps may be taken thereafter by SEBI and UTI to take action against the wrongdoers including referring appropriate matters to an independent investigative agency.

252. 16.39

The Committee desire that UTI also immediately address the issues of concurrent audit of dealing room operations, documentation of decisions regarding secondary market transactions, proper management and security of the voice recording system in the dealing room, introduction of stop loss limits for the dealing room operations and separation of responsibility and authority for fund management and dealing room

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- operations. The UTI Board of Trustees and the Executive Committee including the Chairman should have ensured that these lacunae were attended to in time.
253. 16.47 The Committee deplore the imprudent manner in which stocks were purchased and retained, leading to a host of malpractices which require comprehensive audit and pre-investigation by a suitably empowered body before proceeding to the investigative level. The Committee are satisfied with the process adopted by UTI in respect of the investment decisions in the case of 19 companies. The Advisory Board on Bank, Commercial and Financial Frauds should expeditiously take a final decision on these. The Committee recommend that the procedure suggested by the Tarapore Committee also be adopted in the case of investment decisions in the remaining 70 cases, as this meets the ends of natural justice. The Committee desire that the entire process should be completed within six months of the presentation of this report to Parliament. There is no cause for further delay in this matter.
254. 16.50 The Committee put on record, their disapproval of the decision making process, rather the lack of it, in this private placement. The Committee conclude that UTI's investment in sanctioning Rs 32.08 crore towards the purchase of 3,45,000 shares of Cyberspace (of a face value of Rs. 10) at a price of Rs.930 per share was irregular and violated norms of prudential decision making and notwithstanding Shri Subramanyam's denials, possibly influenced by extraneous considerations. The Committee are aware that criminal proceedings in this matter are pending, but see no reason why departmental proceedings should not be initiated simultaneously in case of the officials concerned. In this regard RBI's recent circular dated 3/5/2002 addressed to all commercial banks regarding bank frauds, specifically states, "...departmental action against officials involved in bank frauds should invariably be initiated simultaneously with criminal action with a view to ensuring that internal fraudsters are immediately punished even if criminal cases against them drag on. At present, there is a tendency among banks to wait for the outcome of criminal action against officials involved for taking departmental action. In view of the salutary effect of this principle, we advise that you initiate departmental action against officials involved in fraud cases simultaneously with criminal action." The Committee are of the opinion that UTI should also follow this principle, and initiate a time bound departmental vigilance enquiry in this matter. As recommended earlier this should also be done in all cases where ERC's recommendations were not sought or its recommendations were overruled.
255. 16.53 The Committee highlight this transaction as another serious violation of norms in UTI and accordingly recommend investigation into the entire transaction, including possible extraneous considerations which might have actuated it. Moreover, the Committee deplore the failure of UTI to pursue recovery proceedings against a corporate, which sought
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investment from UTI on the basis of an undertaking that it would compensate UTI for any loss in the transaction. The Committee recommend that UTI should vigorously pursue all civil and criminal avenues to recoup its investment in Numero Uno International in a time bound manner. UTI should review the role of both Numero Uno International as well as the company that arranged the transaction and take action against them in case there is evidence that they misrepresented the true affairs of the company while seeking investment from UTI. The Committee also recommend that UTI should take immediate steps to hold the concerned officials who processed this transaction accountable and take action against such officials. Besides other actions, law permitting, UTI should initiate civil proceedings of damages against its concerned officials including the then Chairman to recover the losses sustained by its unit holders for a decision which they took without due diligence and in violation of UTI's norms and procedures.

256. 16.56

The Committee are of the view that UTI cannot escape its responsibility to investors in its guaranteed assured return schemes. Those responsible for launching these assured return schemes must be held accountable for their actions and proceeded against. Moreover, the Committee does not find the position taken by IDBI as guarantor of UTI to be in consonance with the canons of sound corporate governance. The Executive Committee of the Board of UTI which sanctioned these schemes in 1996-97 and 1997-98 in violation of SEBI guidelines comprised Chairman, UTI appointed with the concurrence of IDBI; CMD, IDBI as its nominee; Executive Trustee appointed by IDBI; and another trustee functioning as the IDBI nominee. It is therefore clear that all functionaries who participated in this decision represented IDBI. Therefore the Committee cannot accept IDBI's claim that UTI did not frame its assured return schemes within the knowledge of IDBI as guarantor. IDBI should hold its appointees responsible for not framing UTI's assured return schemes in compliance with SEBI guidelines.

257. 16.58

The Committee are of the view that despite SEBI's queries and suggestions, UTI continued with policies which were detrimental to its assured return schemes. The Committee however feel that the letter of 26.11.98 from UTI which mentioned that the shortfall as on date for assured return schemes guaranteed by the DRF and other schemes with no such guarantee added up to Rs. 817.03 crore against a corpus of Rs. 600 crore in the DRF was a sufficient indication to the regulator not to clear any further schemes despite which two more of such guaranteed return schemes were cleared before future schemes were finally changed to assure only the first years return and the capital at maturity. The Committee conclude that UTI, from the time of Chairman, Shri G.P. Gupta and Executive Trustee, P.J. Nayak, to the tenure of Chairman Shri P.S. Subramanyam again and again tried to convince SEBI that its assured return schemes could not fail, when obviously they could and did. SEBI was skeptical but was unable to persuade UTI to

reassess the assurances it was persisting with. Details submitted by UTI (Appendix-XXIII) show that the Executive Committee of UTI met eleven times between January 1997 and December 1998 to approve these schemes in which income distribution as well as capital were assured until maturity. Three officials were members of the Executive Committee throughout this period, Sh. G.P. Gupta (a member throughout this period, first as Chairman, UTI and then as Chairman, IDBI), Sh. P.J. Nayak (Executive Trustee throughout this period) and Sh. N.S. Sekhsaria (IDBI nominee throughout this period). Besides these officials, Sh. S.H. Khan, former Chairman, IDBI, was an IDBI nominee on the Executive Committee for eight of these meetings while Sh. P.S. Subramanyam was a member for two of the meetings, in September and December 1998, after he became Chairman UTI. S/Shri G.P. Gupta and P.J. Nayak kept giving reports to SEBI about the health of these schemes based on erroneous projections, while the Executive Committee kept on clearing new ones. The Committee disapprove these actions and expect a better level of managerial competence from such officials. The episode also highlights the need for all UTI schemes to be statutorily brought under SEBI regulations without any further delay.

258. 16.60 The Committee are of the view that the hybrid nature of UTI and the absence of a regulatory mechanism in respect of its transactions, was the source of its problems. The supply of liquid funds to finance redemptions and pay out in various schemes dried up on account of participation in project financing through consortium lending and investments in debentures, all of which required long gestation periods for adequate returns. The overwhelming representation of IDBI on the Board of UTI made it difficult for UTI to act as a pure mutual fund and made it participate in such lending activities that resulted in huge NPA's low returns and liquidity problems. UTI's activities from the early nineties deviated from the discharge of its functions on sound business principles and disregarded the interests of unit holders. The Committee recommend that UTI be prohibited from undertaking business activities not allowed to mutual funds under SEBI guidelines.

#### UNIT SCHEME-64

259. 17.12 The Committee feel that while the management of UTI must be held accountable for the violation of prudential norms in declaring dividends in excess of income for four continuous years from 1994-95 to 1997-98, especially when reserves were not adequate to cover the value of the units at the administered redemption price, the Ministry of Finance too must bear responsibility for tardy action on the 1993 Vaghul Committee recommendations as well as the 1999 Deepak Parekh Committee recommendations.
260. 17.14 The Committee concur with the observation of the Tarapore Committee that the quantum jump in the inter scheme transfers from/to US-64 in the last three years raises concerns about the bonafides of such transactions and whether they were for window dressing the results of different schemes.



price need to be adjusted in such way as that it retains the flexibility of moving it upwards gradually till at least Feb/March, 2002 (when the scheme is likely to become NAV driven). In case a price much higher than the underlying NAV is fixed in July, 2001 and the market remain flat in the next six to eight months, it would result in abrupt price adjustment in February/March. As an alternate necessary price adjustment may be carried out while deciding the pricing for July, 2001 itself so that there is potential for appreciation subsequently.

- 12% dividend in June 2001 would be equivalent to dividend yield of 8.89% (tax free) on the sale price of 13.50 per unit in July, 2001. The comparable yields for 12 months instruments are:
  - 364 days treasury bill: 8.46% (taxable)
  - AAA Corporate bonds 9.87% (taxable)
  - Fixed Deposits in Commercial Banks: 7.5% - 8.5% (taxable)
  - PSU tax-free bonds 7.25%- 8.00%
- On the present unit capital of Rs. 14,655.67 crore, the dividend requirement at the rate of 12% would be Rs. 1,760 crore. Last year on the outstanding unit capital of Rs. 15,146.26 crore, the investment under RIP was Rs. 631 crore (cash value). Considering the same proportion for RIP this year also, RIP may be in the range of Rs. 500 crore. The net cash requirement for dividend thus may be in the range of Rs. 1260 crore.
- The external factors comprising surge in Nasdaq following 0.5% cut in Fed Funds rate and the improvement in Dow are expected to have positive impact. U.S. market appears to have absorbed the profit warnings in Tech sector and there is an expectation of improvement during the July - December, 2001. Capital raising by Satyam to be followed by similar efforts from leading corporates are also expected to provide a positive push to the market.
- UTI will be continuously reviewing the position.

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Chairman, UTI's letter of 18.5.2001 was not examined by the Ministry, the officers concerned having merely put up the letter to the Minister as an 'FR' (Fresh Receipt) for information without analysing its contents on file either before or after submission to FM. There also appears to be no evidence to suggest that there was any meeting or consultation between Chairman UTI and Ministry of Finance officials between his letters of 18.5.2001 and 29.6.2001. Therefore, while Chairman UTI did keep the Ministry in the dark up to 29.6.2001, the Committee find that despite repeated directives from the Finance Minister to his officials from April 2001 on to find out what was happening in UTI, the officials, as they have informed the Committee, limited their interaction with UTI to

Chairman, UTI's letters of 18 May and 30 June 2001. No analysis was made in the Ministry of the Chairman's letter of 18.5.2001 and the letter itself was treated as an 'FR' (Fresh Receipt) requiring no more than perusal without analysis or follow up. The Minister told the Committee that he was concerned about the impact on UTI of various adverse developments in capital markets and had instructed his officials to find out the facts from UTI, the report the Ministry got from the Chairman UTI was that everything was under control. Even if Chairman, UTI did indeed keep everybody in the dark, as FM told the Rajya Sabha, the Committee find the Ministry did little to bring itself out of the darkness, as it had not instituted any formal mechanism to keep itself informed about the health of the US-64 scheme. Autonomy in day-to-day management of UTI cannot absolve the Ministry of its statutory responsibilities and accountability to Parliament.

264. 17.23

On 29.6.2001 Chairman UTI met with Joint Secretary, Capital Market Division. The meeting was unscheduled and without any prior agenda and there was a discussion on the impending problems of UTI. Thereafter, the JS discussed this subject with the Finance Secretary but no further action appears to have been initiated by the officials of Ministry of Finance. A letter was received from Chairman UTI by Secretary, Ministry of Finance on 30.6.2001 in the evening at his residence, which clearly stated that the UTI Board would meet on 2nd of July and they were considering two options, viz., either

- (i) to freeze US-64 redemptions; or
- (ii) to convert US-64 to NAV basis.

Quite obviously this was a very important piece of news and the Finance Secretary should have acted immediately. Indeed, Finance Secretary Shri Ajit Kumar's action should have commenced immediately after discussion on this subject with the Joint Secretary on 29.6.2001. He could have tried to evolve methods to avoid redemption crisis and also discussed the matter with the Finance Minister immediately. The Secretary mentioned this fact to the Finance Minister only on the morning of 2.7.2001 after the weekend was over. Particularly after receiving a formal letter from Chairman UTI on 30.6.2001 indicating the two options to be placed before the Board of Trustees, taking no action to immediately discuss the matter with the Finance Minister or find solutions to the serious problem that could arise consequent to the Board meeting on 2.7.2001 shows that the Secretary considered the problem in a routine and casual manner which is not expected from an officer of his rank.

#### ROLE IN THE CALCUTTA STOCK EXCHANGE PAYOUT CRISIS

265. 18.18

Having gone through the various enquiry reports and depositions, the Committee are of the view that:

- (i) The unit holders of UTI have been subjected to a loss of Rs. 21.40 crore as on 28.6.2002 on an investment of Rs. 25.13 crore made by UTI based on a decision which violated norms of prudent decision making.

- (ii) Shri P.S. Subramanyam, the then Chairman and late Shri M.M. Kapur, Executive Director approved the transaction which any prudent person could have foreseen would lead to a loss to UTI.

The Committee recommend that UTI and the Ministry of Finance follow up and expedite all the proceedings mentioned in para 18.17, which were initiated as a result of their enquiry into UTI's off market transaction with CSE. In this connection, the Committee suggest that the investigative agencies examine the telephone records of Shri P.S. Subramanyam and others concerned to ascertain who was in touch with whom on 9.3.2001.

266. 18.19

The Committee have had occasion to examine the CSE, Stock Holding Corporation of India (SHCIL), SEBI, UTI and their officials in different sittings while looking at the crisis on CSE. The share transaction funding schemes of SHCIL were extensively used by one of the defaulting CSE brokers, Shri Harish Chandra Biyani to fund transactions in the shares of DSQ group. As there was *prima facie* evidence before the Committee that SHCIL had violated prudential norms and internal procedures to facilitate these transactions, SEBI was asked by the Committee in June 2002 to prepare an inspection report focusing on SHCIL's funding transactions as its earlier report of May 2001 was silent on these aspects. The findings of SEBI's report have been discussed in detail in Chapter IV of Part I of the report. The Committee have in sifting through the reports, depositions and evidence placed before them, observed a disturbing nexus which stands established by the following facts:—

1. Shri P.S. Subramanyam was Chairman of UTI as well as SHCIL at the time of the transaction. UTI is one of the promoters of SHCIL.
2. Shri B.G. Daga was the Executive Director of UTI as well as UTI's representative on the Board of Directors of SHCIL.
3. Shri H.C. Biyani and his related entities were the brokers involved in both transactions.
4. As per the report of SHCIL's Vigilance Advisor and later confirmed in SEBI's inspection report, Shri H.C. Biyani is the broker of Shri Dinesh Dalmia who is the main promoter of the DSQ group.
5. As per the report of SHCIL's Vigilance Advisor, oral evidence tendered to the Committee and later confirmed by SEBI in its inspection report, Shri Dinesh Dalmia lobbied with SHCIL to fund the transaction involving the scrip of DSQ Industries.
6. The transactions of both SHCIL and UTI involved the shares of DSQ group.
7. These transactions took place on CSE in the first and second week of March 2001.
8. UTI had the choice of buying either the scrip of DSQ Software or HFCL but went ahead and bought the former even though there was a specific recommendation by its Equity Research Cell that it should sell its existing holdings of the share.

9. Shri H.C. Biyani and related entities entered into circular transactions on CSE in the scrip of DSQ Industries. They obtained funding from SHCIL through its sell and cash scheme by misrepresenting these transactions as being at arms length. The transactions were later annulled by CSE as on enquiry they found that they were between entities belonging to the same group of persons and appeared to be accommodation transactions.
10. Another large transaction in the scrip of DSQ Industries undertaken by H.C. Biyani and his related company was funded by SHCIL through its cash on payout scheme. SHCIL violated its procedures to facilitate this transaction as well as Shri H.C. Biyani's subsequent discounting of SHCIL's postdated cheque by issuing letters of comfort to IndusInd Bank, which had never been done in any other transaction.
11. According to the SEBI inspection report, companies linked to the promoter of DSQ group provided the shares of DSQ group to Sh. Biyani through off market deals, which he then traded on the CSE.
12. Both UTI and SHCIL's decisions were found to be imprudent, in violation of laid down procedures and have extracted a heavy price in terms of financial loss and loss of reputation and customer confidence.
13. The damage to the vital dealing room tapes recording UTI's transaction with CSE is suspicious.

267. 18.20

The Committee see that all these events point to a close nexus between the corporate promoter, defaulting brokers acting on behalf of the promoter, broker directors on CSE and public officials in SHCIL and UTI. The Committee recommend that the following consequential steps may be taken:

- (i) CBI should expedite its enquiries and subsequent action on the complaint filed by UTI in the matter.
- (ii) The Committee have been informed by the IDBI, one of the promoters of SHCIL, that its nominee is currently the Chairman of SHCIL and that it has decided to carry out a special investigation of SHCIL's role, fix accountability and punish the guilty. The Report has now been received and the Committee desire that it should be followed up expeditiously.
- (iii) SEBI's inspection report on SHCIL has pointed out a number of irregularities. The Committee desire that investigation be concluded without delay and suitable action taken against the concerned persons.
- (iv) The Committee desire that RBI should institute an enquiry regarding the discounting of post dated cheques issued by SHCIL to Biyani

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group by IndusInd Bank. It should direct IndusInd Bank to take appropriate administrative measures if it finds any procedural or regulatory violations. RBI's enquiry should also look at the role of IndusInd Bank in financing all the brokers responsible for the payment crisis on CSE. RBI should also institute changes in the procedure for discounting post-dated cheques if it detects any legal or procedural ambiguities. Indeed this action should have commenced.

- (v) Chairman, SEBI should institute an independent enquiry regarding whether there was any improper conduct by any SEBI official deputed by it to handle the payment crisis at CSE, specifically the antecedents of the deputed official, whether he was sent in the normal course of the responsibilities assigned to him, and if he had any role in facilitating UTI's off market purchase from CSE. Chairman, SEBI should take appropriate administrative action on the basis of the report.
- (vi) SEBI, Enforcement Directorate and DCA have already instituted enquiries in case of the DSQ group, which are at different stages. These should be expedited.

The Committee hope that swift action as detailed above will send the right signals to the stock markets and other financial institutions.

#### ROLE OF TRUSTEES

268. 19.5

The Committee agree that the Board of Trustees must accept constructive responsibility for going along with the UTI management's suggestions for unrealistic dividend rates in these years. The Committee however also recognize the milieu of corporate governance in UTI, the concentration of powers in the hands of the UTI executive, the fact that it was the UTI management which proposed these dividend rates and the compulsions not to lower dividends to avoid large redemptions in the US-64 scheme in this period. Keeping these in view, the Committee are particularly exercised over the role of the Board of Trustees which decided the dividend for the year 1995-96, because the UTI management had specifically proposed a dividend of 15% and a bonus of 1:8 for the US-64 scheme in this year (which according to their calculations gave the unit holders an overall benefit of over 26% for the year and a yield of around 20%) and had also pointed out that anything higher than this would be detrimental to the liquidity and the NAV of the scheme. As the minutes are totally silent about why the suggestion of the UTI management was not accepted and why a much higher dividend of 20% and a bonus of 1:10 was approved, the Committee can only conclude that this may have been done so that the dividend was not too unfavourable when compared to the previous years' dividend of 26%. This still does not explain what prompted the Board of Trustees to overturn the recommended dividend and declare a much

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higher one when the management of UTI had already taken all factors into account and when in all other years the Board of Trustees had accepted the recommendations made to them. This activism on the part of the trustees was disastrous for the scheme as the dividends were distributed from the reserves. The roots of the problems of US-64 lie in these imprudent decisions of the Board of Trustees for which they must bear responsibility.

269. 19.11 Though IDBI has stated that UTI's participation in consortium lending was on its own volition and based on its commercial judgment, the Committee have concluded that given the dominance of IDBI nominees and appointees on the decision making bodies of UTI, the powers of issuing directions granted to IDBI by the UTI Act and government policy promoting directed institutional financing to infrastructure projects, UTI's participation in consortium lending was a foregone conclusion. As much as the declaration of high dividends, it was the imprudent financing of long gestation projects, which lay at the root of the problems that overtook UTI. Also, although IDBI started its own mutual fund in 1994, it continued to dominate the affairs of UTI, despite the obvious conflict of interest. IDBI should have taken the initiative to withdraw itself from control of UTI and its presence on the Board of Trustees of UTI at this stage.
270. 19.13 Whatever may have been the intention of the government in withdrawing its nominee from the Board of Trustees, the stated purpose of letting the institution function autonomously and having a hands off policy did not, in retrospect, bring about any improvement in the functioning of UTI, as subsequent events like the distribution of dividends from reserves and the disastrous investment decisions show. The Committee note that in two of the years when dividend was distributed in excess of the income for the year, *i.e.* 1994-95 and 1995-96, there was a government nominee on the Board. It therefore seems to the Committee that the presence or absence of a government nominee on the Board of UTI did not result in improvement or deterioration of the functioning of UTI.
271. 19.16 In the light of the conflicts of interest discussed above, the Committee recommend that IDBI should be divested of its representation on the Board of Trustees as well as the powers given to it under the UTI Act. Similarly SBI and other public financial institutions should also withdraw from the Board for the same reason. RBI, whose role is of a regulator, should also not have representation on the Board of Trustees of UTI.

#### MINISTRY OF FINANCE AND UTI

272. 20.5 The Committee conclude that between 1992 and 1996, the Ministry had identified the need to delink UTI's mutual fund activities from its term lending activities, the need to bring UTI's mutual fund activities under SEBI regulations, the need to do away with IDBI's role in UTI and the consequent need to amend the UTI Act. The Ministry's own view

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regarding the need to amend the UTI Act also had the mandate from Parliament as well as the backing of the Central Bank and the Capital Market regulator. Only the top management of UTI was reluctant to amend the Act and restructure the institution, and the Ministry indirectly supported the *status quo* in UTI by implementing interim measures in 1994 like UTI coming voluntarily under the regulation of SEBI since statutory regulation by SEBI would have required an amendment of the UTI Act.

The Ministry had subsequently decided to discuss comprehensive proposals regarding restructuring UTI and amendment of the UTI Act in the High Level Committee on Capital Markets and sought UTI's proposal on a suitable legal structure for UTI but the UTI management was not convinced about the need to restructure and failed to act on this. It was only in 1996, with a change in the top management of UTI that it agreed to restructure itself and sent a comprehensive proposal to the Ministry in October, 1996 that involved possible amendment of the UTI Act. However, now that all stakeholders were agreeable to restructuring UTI and an amendment of the UTI Act, it was the Ministry that strangely fell silent, took no further action on UTI's proposal and did not place it before the High Level Committee on Capital Markets.

RBI reminded the Ministry of its organisational and statutory obligations in October, 1999. The Ministry again decided to pursue amendments to the UTI Act by interacting with UTI after which UTI appointed the Malegam Committee, by which time the crisis in UTI became public.

The mandate regarding the organisational matters of UTI and the administration of the UTI Act lies with the Capital Markets Division in the Department of Economic Affairs of the Ministry of Finance. The failure of the Ministry to push amendments to the Act between 1993 and 2001 despite identifying the organizational and statutory weaknesses in UTI reflects poorly on its functioning. There seems to have been a reluctance to push UTI although other stakeholders were convinced about the need for restructuring. Even when UTI management had agreed to restructure the institution, the matter was not taken to its logical conclusion, which reflects a degree of institutional amnesia and a lack of urgency with no system of setting any deadlines by which certain actions were to be taken. This resulted in matters being delayed inordinately by in depth discussions, which were not followed up by action on the ground. The Committee are of the view that this malaise in the Ministry needs to be urgently addressed by reviewing the administrative decision-making mechanisms in the Ministry.

273. 20.13 Though the government's responsibility for UTI was not written into the UTI Act, 1963, its accountability for UTI's US-64 scheme to Parliament became obvious when the scheme was kept out of the purview of the market regulator. After the recent legislation repealing the UTI Act of 1963, its accountability for US-64 and UTI's assured return schemes has become explicit. Successive Ministers of Finance have confirmed to the Committee that they took care to keep themselves informed of matters

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affecting UTI in general, US-64 in particular, and activities in the capital markets that could have a bearing on the financial health of UTI and its several schemes. The crisis in UTI in 1998, including its impact on US-64, led to a pro-active role by government in assisting UTI to recover its financial feet. It also provided the opportunity for interaction between the Ministry and UTI to sort out several issues pertaining to risk management, unit holder protection and asset management. Regrettably, negligent management by UTI and inadequate monitoring on these fronts contributed in significant measure to the crisis in UTI generally and US-64 in particular which led all issues relating to UTI being added to the terms of reference of the Committee in July, 2001.

274.

20.14

The Committee observe that UTI was undoubtedly flush with large funds. The shape of UTI's investment portfolio and subscriber profile also underwent a change from its inception in 1964 to the present redemption problem. It has been stated by all the Finance Ministers that this Committee had the occasion to listen to that the Government did not want to interfere in the day-to-day working of UTI. The UTI Board consisted of eminent persons whom the Government considered to be quite competent to deal with the affairs of UTI. Whether the Government interfered too much in the affairs of UTI and influenced its decisions, or kept inadequate watch on the affairs of the UTI and kept away from its responsibility, was something that the Committee considered very deliberately. There was also a variation in the view of the Government with regard to this aspect. The Government's nominee on the Board of the UTI has always been through IDBI and not directly. While in 1994 it was decided to retain the Ministry of Finance nominee on the Board of UTI, in 1997 the Government decided that there was no need for any Government official to be on the UTI Board and that UTI should have full autonomy with regard to its functioning. Consequently, the Government representative on the Board was withdrawn on 1.5.1997. However, after the redemption problem and the debate in Parliament on the subject, the Government decided to again place its nominee on the UTI Board. The Committee are of the view that the communication between the Ministry of Finance and the UTI has been, over the years, very uneven and no management information system was formalised which could have given the Ministry some lead indicators of any trouble brewing in UTI's finances. The Committee feel that since the US-64 scheme was not subject to SEBI guidelines, was not NAV based, had a large investor base, held a huge stake in the equity markets and had been bailed out earlier, the Ministry of Finance should have been more pro-active in devising a formal mechanism like a monthly management information system about the US-64 scheme to be sent by UTI, so as to monitor its health. If such a system had been put in place, the Ministry of Finance would have been able to deal much more promptly with UTI, when the stock market showed volatility, the share prices fell steeply and the US-64 scheme faced liquidity problems due to redemption pressures.

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## FUTURE ROLE

275. 21.9 The Committee would like to put on record the following observations and recommendations:
- (i) The financial institutions that have been chosen to sponsor UTI-II have in the past sponsored their own mutual funds. Also, both LIC and SBI previously had their nominees on the Board of Trustees of UTI and the Committee have elsewhere commented on the conflict of interest and the need for these institutions to separate themselves from UTI. The Committee therefore recommend that the institutions chosen to sponsor UTI should be those that have not sponsored their own mutual funds. In case this is not found feasible, the Government must spell out in detail both through legislation and through policy guidelines as to how it proposes to insulate UTI-II from the inherent conflict of interest as regards these institutions.
  - (ii) There are a number of civil, criminal, departmental and vigilance proceedings pending in UTI with regard to the irregularities in its investment decisions. The Committee have also recommended certain actions to enforce accountability for previous misdemeanors. The Committee recommend that legislation regarding UTI as well as Government policy should take these proceedings into account so that they are concluded expeditiously and are not hampered by the fact that the UTI Act of 1963 has been repealed.
  - (iii) The Government has stated that a Government appointed administrator and a team of advisors nominated by the Government will manage UTI-I. It needs to be pointed out that even in the case of the assured return schemes and US-64 which are under the purview of UTI-I, day to day decisions have to be taken regarding buying, holding and selling of stocks. This is not an activity which can be conducted by Government officials because the procedures and processes in Government do not allow quick commercial decisions. The Committee therefore recommend that the schemes in UTI-I should also be managed by independent fund managers preferably from UTI-II through a fee based relationship. The management fee can be worked out keeping in mind that the Government has already provided a huge bail out to UTI.
  - (iv) UTI can derive optimum value for equity holdings across schemes that constitute significant portion of the controlling stake of a company by selling them through strategic or private placement. The Committee recommend that a suitable system be devised so that such equity holdings of UTI-I and UTI-II are divested together so that maximum benefit can accrue to the investors in these funds.
  - (v) Government has stated that a professional Chairman and Board of Trustees will manage UTI-II and that advertisements for
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appointment of professional managers will be issued. The Committee recommend that it should be ensured that the selection of the Chairman and professional managers of UTI-II should be done in a transparent manner, whether they are picked up from the public or private sector. If an official from the public sector is selected, in no case should deputation from the parent organisation be allowed and the person chosen should be asked to sever all connections with the previous employer. This is imperative because under no circumstance should there be a public perception that the mutual fund schemes of UTI-II are subject to guarantee by the Government and will be bailed out in case of losses.

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# REPORT

JOINT COMMITTEE  
ON  
STOCK MARKET SCAM  
AND  
MATTERS RELATING THERETO

(THIRTEENTH LOK SABHA)

(VOLUME II – APPENDICES)

*Presented to Lok Sabha on 19 December, 2002  
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