WTM/GM/MIRSD/32/2020-21

SECURITIES AND EXCHANGE BOARD OF INDIA

ORDER

UNDER SECTION 15-I (3) OF THE SECURITIES AND EXCHANGE BOARD OF INDIA ACT, 1992.

IN THE MATTER OF INDIA RATINGS AND RESEARCH PRIVATE LIMITED [SEBI Registration No. IN/CRA/002/1999]

Background

1. India Ratings and Research Private Limited ("**IRRPL**" / "**Noticee**"), is a SEBI registered Credit Rating Agency ("**CRA**"), having its registered office at Wockhardt Tower, 4th Floor, West Wing, Bandra Kurla Complex, Bandra East, Mumbai - 400 051.

2. On account of default committed by Infrastructure Leasing & Financial Services Limited ("**IL&FS**" / "**Issuer**") and its subsidiary company IL&FS Financial Services Ltd. ("**IFIN**") on their obligations in respect of the Commercial Papers ("**CPs**"), Inter-Corporate Deposits ("**ICDs**") and default on interest payments on its Non-convertible Debentures ("**NCDs**"), SEBI undertook an examination with respect to the role of the CRAs, including the Noticee in assigning rating to various NCDs of IL&FS. It was observed that IL&FS had defaulted on its obligations in respect of the CP and ICDs which were due for payment on September 14, 2018. The said CP was rated by the Noticee amongst other CRAs. Subsequently, IL&FS also

defaulted in the interest payments on its NCDs on various dates i.e. September 17, 21, 26 and 29, 2018.

3. The examination indicated that, prima-facie, the Noticee was liable for the following violations:

   a. Excessive reliance placed on the submissions of the management of IL&FS.

   b. Over reliance on the statements made by the management of IL&FS regarding the proposed rights issue towards meeting the debt obligations.

   c. Failure to change the Rating Outlook or place the rating under Credit Watch.

   d. Failure to consider updated Asset Liability Mismatch ("**ALM**") statement / maturity profile of the issuer.

4. In view of the above, SEBI initiated adjudication proceedings against IRRPL for alleged violation of Regulation 24(7) and Clauses 4 and 8 of Code of Conduct for CRAs, read with Regulation 13 of SEBI (Credit Rating Agencies) Regulations, 1999 (" **SEBI** (**CRA) Regulations**") and a Show Cause Notice dated December 17, 2018 ("**SCN1**") was issued to IRRPL in the matter .

5. The Adjudicating Officer ("**AO**"), vide AO order no. SS/AS/2019-20/6282 dated December 26, 2019 ("**AO Order**"), inter-alia, found that the Noticee, while assigning its credit rating to the NCD of IL&FS, failed to exercise proper skill, care and due diligence while discharging its responsibilities as a CRA and thereby violated the provisions of Regulation 24(7) and Clauses 4 and 8 of Code of Conduct of the CRAs read with Regulation 13 of SEBI

(CRA)Regulations and imposed a penalty of Rs.25,00,000 on the Noticee under Section 15HB of the Securities and Exchange Board of India ("**SEBI**") Act, 1992.

6. SEBI examined the AO Order and observed that that the penalty imposed by AO appeared to be erroneous and not commensurate with the overall impact these violations had on the market. In view of the same, the competent authority granted approval to review the AO order.

Show Cause Notice

7. A Show Cause Notice dated January 28, 2020 ("**SCN**") was issued to the Noticee under Section 15-I (3) of the SEBI Act, calling upon the Noticee to show cause as to why enhanced penalty should not be imposed on the Noticee in terms of Section 15HB of the SEBI Act, 1992, for violation of the provisions of Regulations 13 and 24(7) and Clauses 4 and 8 of the Code of Conduct stipulated in Schedule III of CRA Regulations. The SCN, inter-alia, alleged that the Noticee failed to anticipate the mounting credit risks of the issuer and place the ratings accordingly to alert the market in advance, resulting in losses to investors and observed that the AO Order is erroneous and not in the interest of securities market. Accordingly, it was proposed to pass an order enhancing the quantum of penalty.

Reply of the Noticee to the SCN

8. The Noticee, vide letter dated February 11, 2020, acknowledged the receipt of the SCN and informed that it had filed an appeal before Hon'ble Securities Appellate Tribunal ("**SAT**") challenging the AO Order. Noticee also requested to keep the extant proceedings in abeyance till the time the appeal filed by the Noticee is disposed by SAT. SEBI, vide email dated March

02, 2020, intimated the Noticee that their request for keeping the matter in abeyance was not acceded to as SAT has not granted any stay on the SCN. Noticee, vide email dated March 13, 2020, inter-alia, sought an opportunity to inspect relevant documents relied upon in the SCN. Considering the lock-down and situation prevailing on account of Covid-19, an opportunity for electronic inspection of relevant documents was granted to the Noticee on June 19, 2020. As requested by the Noticee, an opportunity for personal hearing through video conferencing was also granted to the Noticee on June 29, 2020, which was attended by Pesi Modi, Sandeep Parekh, Rohit Swahney, Ananda Bhoumik, Deepika Goyal, Advocates, and Anuj Berry and Neville Lashkari, authorised representatives of the Noticee. Gist of oral submissions made therein and subsequent written submissions made vide letter dated July 06, 2020, is given below:

a. The Noticee has filed an Appeal against the AO Order before SAT and requested for stay of the current review proceedings till SAT disposes of the said Appeal.

b. The current proceedings under Section 15-I(3) of the SEBI Act is not an appellate jurisdiction and are not maintainable as the requirements stated therein including 'examination of facts', 'error' in AO Order 'to the extent that it is not in the interest of securities market' are not met.

c. The SCN does not point out what is erroneous in the AO Order or quantifiable gains or losses caused.

d. AO has observed that there was no evidence of malafide in the matter.

e. Section 15-I(3) of the SEBI Act is in pari materia with Section 263(1) of the Income Tax Act, 1961 and Hon'ble Supreme Court, in various judgements, had held that this provision could not be used to substitute the view of the Assessing Officer with that of another superior officer.

f. Hon'ble Bombay High Court, in SEBI vs I-Kisan, held that a case should not be reopened in hindsight.

g. No incremental / additional loss has been caused due to delay in degrading ratings by the Noticee.

h. Quantum of penalty should be commensurate with the violations. The allegations in the matter are negligence and delay and in case of Brickwork Ratings India Private Limited involving similar allegations, a penalty of Rs.3 lakh only was imposed.

i. SAT, vide order dated July 01, 2020 in Miscellaneous Application No. 159 of 2020 filed by the Noticee, has, inter-alia, permitted the present proceedings to continue but has directed that any order that maybe passed therein shall not be given effect to during the pendency of Appeal No. 103 of 2020 filed by the Noticee challenging the AO Order.

j. The present proceedings were only for consideration as to whether the quantum of the penalty imposed under the SEBI Order is to be enhanced and not for reconsideration of the merits of the case which had been set out in the show-cause notice dated December 17, 2018 and which has already been considered and decided by the AO Order.

k. Section 15-I(3) of the SEBI Act, inter-alia, requires following conditions to be satisfied, none of which have been met in the present matter:

   i. SEBI must make an appropriate inquiry and examine the record of the adjudication proceedings;

   ii. SEBI should be of the considered opinion that the order passed by the adjudicating officer is erroneous;

   iii. Such errors in the order of the adjudicating officer must be such as are detrimental to the interests of the securities market.

l. SCN was issued within a month from the date of the AO Order and no inquiry or examination appears to have been conducted by SEBI before issuing the SCN.

m. Extraordinary powers under Section 15-I(3) can only be exercised after an independent examination and investigation of the records of the proceedings, which should result in a prima-facie finding that the order issued by the adjudicating authority is patently or grossly erroneous. However, SEBI has not provided any evidence of any such examination or inquiry conducted by it prior to initiation of the proceedings under the SCN.

n. SCN fails to identify which findings in the AO Order are now being alleged to be erroneous or as to why the same are alleged to be erroneous and hence, the SCN is is totally vague, misconceived and untenable.

o. Even if it is only the quantum of penalty which is now being alleged to be "erroneous", such alleged error is not what is contemplated by Section 15-I(3) of the SEBI Act.

p. The SCN does not even disclose any reasons or rationale or basis or computation or formula in support of the allegation that the penalty ought to be enhanced.

q. The SCN fails to elucidate or explain the basis for alleging that the AO Order is not in the interests of the securities market, which is one of the conditions precedent for initiation of proceedings under Section 15-I(3).

r. The Noticee had no role in the alleged fraud and default by IL&FS and there is no allegation of any mala-fide against the Noticee. It is totally incorrect to allege that any act or omission of the Noticee has caused any loss to the investors. The loss has been caused to investors by the inability of IL&FS to pay its financial dues and not because of any rating given by the Noticee.

s. There is express finding in the AO Order that there is no evidence of any quantifiable gain or unfair advantage accrued to the Noticee or the extent of loss, if any, suffered by the investors as a result of the alleged default / lack of due diligence by the Noticee. This finding is not disputed or controverted in the SCN also. Therefore, there is no basis, justification or rationale to impose a higher penalty.

t. The penalty of Rs. 25,00,000 already imposed by the AO Order is itself excessive and exorbitant. In no other case has SEBI levied such a huge penalty for alleged failure of due diligence by any intermediary, much less for the failure of a credit rating agency to downgrade its ratings.

u. The Noticee has a totally clean track record and has never been subjected to any proceedings by SEBI, RBI or any other regulator. It has an impeccable reputation.

v. In view of the above, the SCN is totally vitiated by fatal defects on all counts as aforesaid and the same is contrary to law and contrary to the facts on record. SCN is totally irrational and unsustainable and the Noticee is liable to be discharged forthwith.

w. The present proceedings under the SCN are untenable, unsustainable and contrary to law and therefore, ought to be withdrawn or discharged with no adverse findings against the Noticee or any enhancement of penalty and the Noticee be discharged from the present proceedings with no adverse findings or orders or any enhancement of the penalty.

Preliminary Objections on the Scope of Review under Section 15 I- (3) of the SEBI Act

Powers of SEBI under SEBI Act distinguishable from other Statutes:

9. Section 15 I-(3) of SEBI Act reads as follows:

" The Board may call for and examine the record of any proceedings under this section and if it considers that the order passed by the adjudicating officer is ***erroneous to the extent it is not in the interests of the securities market****, it may, after making or causing to be made such inquiry as it deems necessary, pass an order enhancing the quantum of penalty, if the circumstances of the case so justify:*

Provided that no such order shall be passed unless the person concerned has been given an opportunity of being heard in the matter:

Provided further that nothing contained in this sub-section shall be applicable after an expiry of a period of three months from the date of the order passed by the adjudicating officer or disposal of the appeal under section 15T, whichever is earlier."

10. In this connection, the Noticee had raised two main preliminary objections, such as (i) the SCN not detailing the errors in the AO order or as to how it has affected the interest of the securities market; and (ii) the maintainability of review proceedings while the AO order is itself under challenge before the SAT. The Noticee placed reliance on section 263(1) of the Income tax Act to state that it is in *pari materia* with section 15-I (3) of the SEBI Act and stated that the powers of review can be exercised only if the twin conditions precedent for such exercise exist, i.e. only when the Commissioner is satisfied that the order of Assessing Officer is "erroneous" as well as "prejudicial to the interests" of the Revenue. It was further contended that the notice of review ought to have brought out the specific errors in the AO order, failing which the Notice is invalid, by citing the above judgments.

11. The relevant part of Section 263(1) of the Income Tax Act is reproduced hereunder:

"*(1) The Principal Commissioner or Commissioner may call for and examine the record of any proceeding under this Act, and if he considers that any order passed therein by the Assessing Officer is* ***erroneous in so far as it is prejudicial to the interests of the revenue****, he may, after giving the assessee an opportunity of being heard and after making or causing to be made such inquiry as he deems necessary, pass such order thereon as the circumstances of the case justify, including an order enhancing or modifying the assessment, or cancelling the assessment and directing a fresh assessment.*

Explanation 2.—For the purposes of this section, it is hereby declared that an order passed by the Assessing Officer ***shall be deemed to be erroneous in so far as it is prejudicial to the interests of the revenue****, if, in the opinion of the Principal Commissioner or Commissioner,—*

(a) the order is passed without making inquiries or verification which should have been made;

(b) the order is passed allowing any relief without inquiring into the claim;

(c) the order has not been made in accordance with any order, direction or instruction issued by the Board under section 119; or

(d) the order has not been passed in accordance with any decision which is prejudicial to the assessee, rendered by the jurisdictional High Court or Supreme Court in the case of the assessee or any other person."

12. The contention that the aforesaid provisions of the IT Act and the SEBI Act are in *pari-materia* is misplaced. At the outset, it needs to be stated that the primary purpose for which SEBI is founded is to protect investors, to maintain the fairness and safety of the securities markets and to facilitate capital formation. Therefore, conceptually there exists a fundamental difference between the powers conferred on the Board under the SEBI Act and SEBI's functions on one side and the Income Tax Department, the purpose of the income Tax Act and the functions of the authorities under the IT act on the other. It is an established principle of law, as elaborated by the Supreme Court of India in the case of *Shah & Co., Bombay V. The State of Maharashtra & Anr*, 1967 AIR 1877, that provisions of two enactments cannot be considered to be in *pari materia* if they deal with totally different subject matters, and do not relate to the same person or thing, or to the same class of persons or things. In the present case, the two Acts i.e., the IT Act and the SEBI Act deal with different subject matters and relate to two different purposes. The schemes of both the Acts are totally different. Both deal with two different and incomparable situations and are different in terms of objectives and policy. The assessment of income tax liability carried out by the Assessing officer under the IT Act for the levy of income tax is starkly different from the adjudication of alleged violations, by an AO for the purpose of imposition of penalty under the SEBI Act. The expression

"prejudicial to the interests of the revenue" relates to the reduction in revenue arising out of an error in the factual assessment of income tax liability of an entity. Contrary to this, the expression "not in the interests of securities market" in the context of an Adjudicating Officer's order is an expression which has a wider ramification and also includes within it an element of public interest and social welfare.

13. In this connection, it is also relevant to rely on the judgment in the matter of *Securities and Exchange Board of India v. Alka Synthetics Ltd.*, (AIR 1999 Gujarat 221). The question that arose for consideration in this case was whether SEBI had the power under the SEBI Act to impound or forfeit the monies received by the stock exchanges towards squaring off the outstanding transactions. The Division bench of the Gujarat High Court considered the appeal filed by the Board against the verdict of the Single Judge, in the context of interpretation of powers of SEBI under the SEBI Act, the Court observed that "… *in the very beginning, the learned single judge has approached and decided this question on the basis of the principles of law, which have been laid down by the courts in matters relating to fiscal and taxing statutes and the inhibition against the imposition of levy and collection of any tax and the consequential deprivation of property. In our considered opinion, the very approach and the principles on which this question has been decided by the learned single judge were not at all germane because here is a case in which the court is concerned with the provisions of a comprehensive legislation, which was enacted to give effect to the reformed economic policy investing the SEBI with statutory powers to regulate the securities market with the object of ensuring investors' protection, the orderly and healthy growth of the securities market so as to make the SEBI's control over the capital market to be effective and meaningful.*"

14. In *Babu Khan And Others vs Nazim Khan (Dead) By Lrs. & Others***,** Appeal (Civil) 774 of 1997, judgment dated April 16, 2001 **,** in the context of comparison of the provisions of the Madhya Bharat Land Revenue and Tenancy Act and its repealing Act, namely the MP land Revenue Code, the Apex Court observed as "*It is true that the courts while construing a provision of an enactment often follow the decisions by the courts construing similar provision of an enactment in pari materia. The object behind the application of the said rule of construction is to avoid contradiction between the two statutes dealing with the same subject….It is not sound principle of construction to interpret a provision of an enactment following the decisions rendered on similar provision of an enactment when two statutes are not in pari materia.*"

15. As discussed in the above cases, it can be seen that the IT Act and the SEBI Act do not deal with the same subject matter and apply to different persons/things. Thus, even though there may be some similarity in the language of Section 263(1) of the Income Tax Act and Section 15-I (3) of the SEBI Act, for the reasons stated above, the said provision of the SEBI Act cannot be interpreted in light of the Income Tax Act.

16. Further, getting into the merits of the two provisions, I note that the Income Tax Act provision contained in section 263(1) has identified 4 types of factual errors, by way of a deeming provision contained in Explanation 2 therein, detailed in paragraph 11 of this Order. The approach of the Noticee of reading the four specific errors of the IT Act into the requirements of review under section 15-I (3) is basically flawed and untenable, when the statute itself has not provided for it, and when the schemes of the two Acts are totally different. As opposed to section 263(1) of the Income Tax Act, the provision in section 15- I(3) of the SEBI Act, empowers the Board to enhance the quantum of penalty imposed by the AO, " if the order passed by the adjudicating officer is erroneous to the extent it is not in the interests

of the securities market". In my view, the powers of the Board to review an AO's order under the SEBI Act is not limited to any specific set of identifiable factual errors, as identified under the Income Tax Act and it could comprehensively cover those cases wherever the adjudication of the issues has culminated in the levy or non-levy of penalty upon the Noticee, which according to the Board, is inadequate to meet the larger interests of the securities market.

Other Preliminary Issues

17. As regards the next issue of the maintainability of the review proceedings while the appeal proceedings are pending in the Appellate Tribunal, it is stated that the second proviso in section 15-I (3) explicitly provides that "*nothing contained in this sub-section* (i.e section 15-I, sub section (3)*) shall be applicable after an expiry of a period of three months from the date of the order passed by the adjudicating officer or disposal of the appeal under section 15T, whichever is earlier."* In other words, the exercise of powers to review gets frustrated upon the disposal of the appeal by the Appellate Tribunal or the expiry of three months from the date of the AO order, whichever is earlier. As the review proceedings have been initiated within the time stipulated in Section 15-I and the same is underway, the Hon'ble Appellate Tribunal also did not interfere in the review proceedings of the Board, when the appeal preferred by the Noticee came up before it for hearing and stated that the proceedings can continue and SEBI can pass appropriate orders in the matter but the order shall not be given effect to during the pendency of the proceedings.

18. Another issue raised by the Noticee is that the SCN does not demonstrate as to how SEBI has come to an opinion that the penalty imposed is insufficient and why a higher penalty should be imposed. Accordingly, it has been stated that the SCN is vague and not specific and

irrational and unsustainable. For quantification of penalty by the AO, certain illustrative parameters have been provided under section 15J of the SEBI Act, such as- *(a) the amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default; (b) the amount of loss caused to an investor or group of investors as a result of the default; and (c) the repetitive nature of the default*. The SCN has clearly indicated that the penalty amount is proposed to be enhanced in the light of the adverse findings of the AO enlisted in Para 3 of the SCN.

19. The AO under the SEBI Act not only adjudicates the violation by application of law to the facts before him, but also is obligated to assess and arrive at an appropriate quantum of penalty, guided by the specific provisions contained in Section 15 J. In other words, the AO's adjudication comprises of a three-fold activity – i) appreciation of facts; ii) application of law; and iii) assessment of quantum of penalty.

20. For the purpose of Section 15- I (3), I am of the view that an error can fall under any of the aforesaid limbs of the adjudication process, provided that the same, in the view of the board, is not in the interests of the securities market. In the instant case, the error falls within the third limb of the AO's adjudication.

21. In this connection, I would like to extract the relevant part of the SCN, as below:

"4. SEBI, after (on) examining the records of the abovementioned adjudication proceedings, is of the opinion that AO Order is erroneous and it is not in the interest of securities market. Accordingly an order is proposed to be passed enhancing the quantum of penalty because Noticee being a registered Credit Rating Agency failed to anticipate the mounting credit risks of the issuer and place ratings accordingly to alert the market in advance which resulted in losses to the investors."

22. Para 4 of the SCN has explicitly brought out the reason for enhancement to be that the failure of the CRA has resulted in loss to the investors. Para 3 of the SCN has enlisted the gist of the lapses, culled out from the AO's Order which according to him warranted the imposition of penalty on the Noticee. A combined reading of Paragraphs 3 and 4 of the SCN sufficiently brings out the reasons of the review to be the inappropriateness of the quantum of penalty from the perspective of loss to the investors. In view of this, I am not inclined to entertain the argument that the Review Notice is invalid for want of specific averments.

23. The Noticee has contended that the discretion of the AO cannot be substituted by the discretion of the Board. There is no question of substitution of the 'discretion' of the Board in place of the discretion exercised by the AO. The power of review conferred on the Board under section 15-I (3) is being invoked to rectify the error contained in the AO's Order, which is not in the interest of the securities market. Arguing otherwise would defeat the very purpose conferring such a review power upon the Board and, in turn, would interfere with the Board's primary function of protection of investors' interest. The Board's power under section 15- I (3) of the SEBI Act is co-extensive with the power of the AO with respect to the specific order under review. Thus, the discretion available to the AO for adjudicating violations under different provisions of the SEBI Act, would be available to the Board as well.

24. Before proceeding further, it is clarified that I concur with the factual findings of the AO, with respect to the conduct of the Noticee, as reproduced in para 3 of the SCN. I am also in agreement with the fact that the AO has chosen to impose a monetary penalty on the Noticee. However, the AO has failed to grasp the gravity of the violation and its consequent impact on the securities market and has failed to gauge the severity of the hit on the investors. Given

this backdrop, the AO has not come up with justifiable grounds to arrive at the quantum of penalty which looks very meagre in comparison to the gravity of the violation. I also refrain from re-opening the specific conduct issues of the Noticee as a CRA, on which the AO has already given his verdict.

Consideration of Submissions on Merit

Factual Background

25. From the perusal of the material available on record, I find it appropriate to summarize the major events leading up to issuance of SCN in the matter, as below:

a. The Noticee has been rating various instruments such a NCDs and CPs issued by IL&FS and its subsidiary IFIN;

b. IL&FS defaulted on its obligations in respect of the CPs and ICDs which were due for payment on September 14, 2018.

c. Subsequently, IL&FS also defaulted in the interest payments on its NCDs on various dates i.e. September 17, 21, 26 and 29, 2018.

d. SEBI, inter-alia, observed that the Noticee assigned 'AAA' rating to the NCDs issued by IL&FS on March 01, 2018, downgraded the rating to 'AA+' on August 24, 2018 and to 'BB' on September 11, 2018 and further downgraded it to 'D' on September 18, 2018.

e. SEBI examined the matter and initiated adjudication proceedings against the Noticee for failing to exercise proper skill, care and due diligence in:

i. Failing to obtain independent confirmation of various claims made by the management of IL&FS and excessively relying on the submissions of the management of IL&FS;

ii. Failing to change the rating outlook or to keep the rating under watch despite being aware of high leverage and delay in implementation of asset monetization plans by IL&FS;

iii. Failing to consider the updated financials / Asset-Liability Mismatch ("**ALM**") position / Maturity Profile of IL&FS;

f. AO, vide order dated December 26, 2019, found that the Noticee, while assigning its credit rating to the NCD of IL&FS, failed to exercise proper skill, care and due diligence while discharging its responsibilities as a CRA and violated the provisions of Regulation 24(7) and Clauses 4 and 8 of Code of Conduct of the CRAs read with Regulation 13 of SEBI (CRA)Regulations and levied a penalty of Rs.25 lakh on the Noticee.

26. As stated at paragraph 24 above, this Order is limited to the review of the exercise of the AO's discretion on assessing the quantum of penalty in his order. The relevant findings of the AO for the limited purpose of bringing out the disparity between his findings and the quantum of penalty imposed, are reproduced below:

a. "*It is undisputed fact that the Noticee had maintained the Rating Outlook on the NCDs of IL&FS as "Stable" throughout the rating period despite the slow pace at which the asset monetization and deleveraging steps of IL&FS was taking place*…" (Para 50 of the AO Order)

b. "*Thus, it is clear that the Noticee despite being aware of the aforementioned facts indicating inordinate delays in monetisation of assets by IL&FS / generating cash flows, maintained the outlook for the debt instruments of IL&FS as stable. Therefore, I note that the Noticee had failed to adequately caution the investors regarding the high leverage and delay in implementation of asset monetization plans by IL&FS.*" (Para 50 of the AO Order)

c. "*I find that though the Noticee has shown its concern regarding aforementioned deteriorating financial factors on continuous basis in its rating rationales, it had not acted upon the same diligently while rating the NCDs of IL&FS. I, therefore, find that the Noticee has failed to exercise its duty to the investors at large and failed to intervene in the matter on time by downgrading the ratings of NCDs of IL&FS despite having knowledge of the deteriorating financials of IL&FS.*" (Para 56 of the AO Order)

d. "*I, therefore agree with observations of examination by SEBI that the Noticee, being a responsible credit rating agency registered with SEBI, should have anticipated the mounting credit risks, the stressed balance sheet position of IL&FS and placed the ratings accordingly to alert the market in advance regarding the deteriorating financial profile of the issuer and reject contentions of the Noticee.*" (Para 57 of the AO Order)

e. *The brazen failure as found in this case, had clearly defeated the purposes of the Regulations i.e. investor protection and orderly development of the securities markets. Considering the role and responsibility of the Noticee in these regards and important obligations cast upon it under the CRA Regulations, in my view, the default is grave and the gravity of this matter cannot be ignored.*" (Para 61 of the AO Order)

27. As noted from the above, the AO Order has categorically brought out the failure of the Noticee to exercise proper skill, care and due diligence in rating the securities issued by IL&FS

and established that such non-compliance attracts monetary penalty under Section15HB of SEBI Act.

28. Ultimately the AO has imposed a penalty of Rs.25,00,000 on the Noticee for the aforesaid violations, which according to the AO, is commensurate with the violation committed by the Noticee in this case.

29. Having dealt with the preliminary objections and the scope of Review under Section 15 –I (3) in the instant matter, I would now like to deal with the role of CRAs in securities market, the role of institutional investors, the scope CRA Regulations, the nature and impact of ratings etc. before I proceed to consider the relevant details leading to the enhancement of the penalty.

Role of Credit Rating Agencies in General

30. As such, credit rating is one of the prerequisites for listing of debt securities and it has a significant role in attracting and retaining investors' interest in the debt securities market. CRAs are specialists that assess and rate the ability of companies, institutions and governments to service their debts. This role of the CRAs entails that their assessment is relied upon by investors (both retail and institutional) and even regulators, thereby making them systemically important for the securities market and the larger economy. Any intending investor in bonds (whether institutional or retail) looks to the ratings assigned by the CRAs as one of the most important indicators of the financial health of the company. While the investor is expected to undertake his/her own due diligence before investing, the investor reposes faith in the ratings assigned by the CRAs ensconced in the belief, and rightly so, that such ratings are assigned by CRAs after a thorough and methodical analysis of the company's financial standing. It goes

without saying that the market keenly looks at the rating assigned not only at the time of initial floatation of bonds, but also during the entire life of the bond, when CRAs are expected to closely monitor the financial health of the company and take decisions relating to the upgrade or downgrade of the rating of bonds. Since, the entire investor universe is segmented in terms of risk appetite, investors enter/exit bonds depending upon the rating migration and in line with their own risk appetite. Thus, ratings have a tendency to determine the inflows/outflows/transaction volumes in the bond market. This is not only true of India but it is a global phenomenon. Given this backdrop, any slip in due diligence by CRAs poses a threat to market integrity.

31. A specific reference is drawn to Subtitle C (Improvement to the Regulation of Credit Rating Agencies) of the Dodd Frank Wall Street Reform and Consumer Protection Act enacted in 2010 by the US Congress in the aftermath of the 2008 financial crisis, for the purpose of highlighting the significant role of CRAs. Section 931 of Subtitle C, which contains the reasons for the framing of the said chapter by the US Congress reads as below:

" Congress finds the following:

(1) Because of the systemic importance of credit ratings and the reliance placed on credit ratings by individual and institutional investors and financial regulators, the activities and performances of credit rating agencies, including nationally recognized statistical rating organizations, are matters of national public interest, as credit rating agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy.

(2) Credit rating agencies, including nationally recognized statistical rating organizations, play a critical "gatekeeper" role in the debt market that is functionally similar to that of securities analysts, who evaluate the quality of securities in the equity market, and auditors, who review the financial statements of firms. Such role justifies a similar level of public oversight and accountability.

(3) Because credit rating agencies perform evaluative and analytical services on behalf of clients, much as other financial "gatekeepers" do, the activities of credit rating agencies are fundamentally commercial in character and should be subject to the same standards of liability and oversight as apply to auditors, securities analysts, and investment bankers.

(4) …

(5) In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies."

32. From the above, it is seen that CRAs are crucial to capital formation, investor confidence, and the efficient performance of the economy. It goes without saying that this is as true for the US economy and market as it is for the Indian economy and market. Further, it is also seen that any inaccuracy in the ratings can contribute significantly to the mismanagement of risks by financial institutions and investors, which in turn can gravely impact the health of the economy.

Scope of SEBI (CRA) Regulations

33. The SEBI (CRA) Regulations mandate registration with SEBI for a CRA to do the credit rating activity. The Regulations prescribe multiple eligibility criteria viz., net worth specifications, infrastructure, professional competence of promoters and fit and proper person criteria, etc. Regulation 13 of the SEBI (CRA) Regulations makes it mandatory for every CRA to abide by the Code of Conduct contained in Schedule –III to the CRA regulations. The first and foremost item in the Code of Conduct is that "A credit rating agency shall make all efforts to protect the interests of investors." (Clause 1). It further provides that "A credit rating agency shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment, in order to achieve objectivity and independence in the rating process." (Clause 4). Clause 6 of the SEBI (CRA) Regulations states, "A credit rating agency shall have in place a rating process that reflects consistent and international standards." Clause 8 provides that "A credit rating agency shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings." Further a credit rating agency shall also monitor closely all relevant factors that might affect the creditworthiness of the issuers. Regulation 15 underlines the importance of continuous monitoring of ratings by every credit rating agency during the lifetime of the securities listed by it, the only exception being cases where the company whose security is rated is wound up or merged or amalgamated with another company. Regulation 15 also casts a duty on every credit rating agency to disseminate information regarding newly assigned ratings and changes in earlier ratings promptly through press releases and websites, and to the stock exchanges. Regulation 24 mandates every CRA to have professional rating committees who are adequately qualified and knowledgeable and be staffed by analysts qualified to carry

out a rating assignment. Rating agencies are also under an obligation to inform SEBI about new rating instruments or symbols. Regulation 24 (7) mandates that every credit rating agency shall "while rating a security, exercise due diligence in order to ensure that the rating given by the credit rating agency is fair and appropriate." Regulation 24 (9) stipulates that "Rating definition, as well as the structure for a particular rating product, shall not be changed by a credit rating agency, without prior information to the Board." Besides the Regulations, SEBI has issued certain clarifications and circulars, from time to time, inter alia, to deal with rating operations, method of monitoring and review of ratings, Standardization of press release for Rating Actions etc. The different and distinguishable requirements with respect to Rating Symbols and Definitions for long and short term debt instruments, structured finance instruments, and debt mutual fund schemes were stipulated in the Annexures of the Circular dated June 15, 2011. Such Rating Definitions with respect to different debt instruments/products/schemes laid down by the Board cannot be changed by a credit rating agency while rating the product of its clients, without the prior information to SEBI.

Critical Role of Institutional Investors

34. The investors in IL&FS securities included institutional and public sector investors including pension and provident funds, which have low risk appetite and follow a conservative investment strategy and these entities would not have invested / continued with their investment in these securities but for the highest credit rating given by CRAs including the Noticee. The credit ratings awarded by the Noticee also serve as an important reference parameter to influence the investment decisions of Institutional Investors, even though they may have their own expertise to assess the inherent risks involved in their investments. I note

that many institutions handling public money such as pension funds, provident funds, mutual funds etc. had kept their investments in the securities of IL&FS, which at that time enjoyed the highest credit rating given by CRAs including the Noticee. Accordingly, I note that substantial public interest was involved in the securities issued by IL&FS and the credit ratings thereon, which were relied upon by the investors to make investment decisions. However, the failure of the Noticee to exercise adequate due diligence with respect to the assessment of the mounting credit risks of IL & FS in the light of its stressed balance sheet position and in turn, the failure to review and modify the ratings on time, so as to alert the market in advance, has resulted in abrupt downgrading of rating of these securities just before the default. In any case, a CRA cannot be heard to contend that its accuracy in ratings should not be relied upon by Institutional Investors.

35. Had the Noticee acted diligently and downgraded the securities on time, the investors having low risk appetite could have exited the securities taking only a portion of the loss and the discounted securities with lower credit rating would then be owned by investors having a higher risk appetite. A timely and gradual downgrading of the securities could have avoided the current scenario, which forced the entire losses arising from the IL&FS default on the conservative and risk averse investors. The AO Order clearly points to certain vital indicators that were overlooked by the Noticee, which could have triggered the exit of low-risk/investors at the right time and helped them minimise the losses.

Details of Instruments/Products of IL & FS Rated by the Noticee

36. The Noticee has been rating various securities of IL&FS and its group companies including IFIN. From the perusal of press releases issued by the Noticee, I note that it had assigned

ratings to NCDs amounting to Rs.1750 crore issued by IL&FS and NCDs amounting to Rs.2600 crore issued by IFIN during the period April 2016 to September 2018. I note that IL&FS is a Systemically Important Non-Deposit Accepting Core Investment Company registered with Reserve Bank of India and lends and invests in IL&FS Group Companies and IL&FS operated through more than 250 subsidiaries which in turn operated in wide range of sectors including engineering and construction, financial services, transportation, energy etc. While there are other companies also engaged in engineering and construction, the scale, diversity of operations and business model of the IL & FS group makes it a kind of a unique company with no real comparable peers in India. I further find that IL&FS was a big conglomerate with significant borrowings. As observed from the Balance Sheet of IL&FS for the year ended March 31, 2018, it had a consolidated borrowing of Rs.91,091 crore including outstanding debentures of Rs.24,297 crore and term loans of Rs.55,870 crore, highlighting its significance to the financial sector and to the securities market. I note that the NCDs, which were given the highest rating by the Noticee and which continued to be so till August 23, 2018, were abruptly downgraded to default grade on September 18, 2018, i.e. within a gap of just 26 days.

37. I further note that a minimum credit rating is essential to raise funds through issuance of debt securities and companies with high credit ratings get to raise funds easily at a relatively lower cost. Credit Ratings also affect the rate of return on debt securities and its liquidity. Thus, an incorrect rating or a serious fault in credit rating not only dents the confidence of the investors of IL&FS but also the general confidence of the investors in the securities market as a whole. This, in turn, would adversely affect the orderly and healthy growth of securities market. It is

relevant to note that the ratings awarded by CRAs are relied upon by issuers, investors and regulators alike and directly impacts the issuers' ability to access capital.

Reasons for Enhancement of Penalty

38. The penalty is proposed to be enhanced for the following reasons:

a. As brought out in the earlier part of the order, the role of a CRA is that of a financial 'gatekeeper'. Any inaccuracy in the rating processes adopted by the CRA has significant negative impact on the securities market.

b. I note that as on the date of downgrading the ratings of NCDs and CPs of IL&FS and IFIN to D on September 18, 2018, the outstanding amount of securities so rated by the Noticee amounted to Rs.16,270 crore.

c. The AO has failed to give due weightage to the magnitude of the loss caused to the investors, despite the same being a specified parameter under Section 15 J of the SEBI Act.

d. Imposition of penalty should have the objective of deterring the Noticee from repeating the violation, and serving as a deterrent to other similarly placed agencies.

e. Imposition of lighter penalties on the Noticee, tends to create a disadvantage for the other CRAs who may have complied with the law.

f. The impact of the violations committed by the Noticee is not limited to the monetary loss caused to the investors of NCDs issued by IL&FS but has had wider and larger

ramifications on the investor confidence, the financial sector and the securities market as a whole. In fact, in the case on hand, the default by IL&FS and the steep downgrade by CRAs in a matter of 26 days has completely changed the risk perception of the corporate bond market.

g. The Noticee has placed reliance on the Adjudication Order dated August 31, 2018 passed in the matter of Brickwork Ratings India Private Limited, to claim that the penalty should be commensurate. The facts, circumstances and market impact of the rating processes may not be comparable. Fact specific AO orders do not carry precedential value.

39. To sum up, I find that the lapses on the side of the Noticee, while rating the securities of IL&FS and IFIN have resulted in real and severe financial loss to investors. It has shaken up the investors' faith in the reliability of credit ratings in the context of the corporate debt market. Had the Noticee downgraded the ratings at the appropriate time and thereby forewarned the investors, the impact of the default on investors who invested in AAA rated instruments, could not have been this severe. Considering the above, I am convinced that the case merits imposition of exemplary penalty provided under Section 15HB of the SEBI Act.

Order

40. In view of the above, I, in exercise of powers under Section 15-I(3) of the SEBI Act, after taking into consideration all the facts and circumstances of the case and the breaches or lapses on the side of the Noticee, as mentioned above, and having found the AO Order dated December 26, 2019 as erroneous to the extent it is detrimental to the interests of securities

market, hereby impose a monetary penalty of Rs.1,00,00,000/- (Rupees One Crore Only) upon the Noticee under Section 15HB of the SEBI Act.

41. The penalty, after adjusting amounts, if any, paid in compliance with the AO Order, shall be paid by way of demand draft drawn in favour of "SEBI – Penalties Remittable to Government of India" payable at Mumbai or by e-payment in the account of "SEBI -Penalties Remittable to Government of India", A/c No. 31465271959, State Bank of India, Bandra Kurla Complex Branch, RTGS Code SBIN0004380, within 45 days of the effective date of this order, as provided in Para No. 41 below being put into effect. The said demand draft or details and confirmation of e-payments made (in the format as given in table below) should be forwarded to "The Chief General Manager, Market Intermediaries Regulation and Supervision Department (MIRSD), Securities and Exchange Board of India, SEBI Bhavan, Plot No. C – 4 A, "G" Block, Bandra Kurla Complex, Bandra (E), Mumbai – 400051" and also to email id:- tad@sebi.gov.in.

Case Name	
Name of payee:	
Date of payment:	
Amount paid:	
Transaction no.:	
Bank details in which payment is made:	
Payment is made for :	

(like penalties/ disgorgement/ recovery/settlement amount and legal charges along with order details)	

42. In the event of failure to pay the said amount of penalty within 45 days of the effective date of this Order, consequential proceedings including, but not limited to, recovery proceedings may be initiated under section 28A of the SEBI Act, for realization of the said amount of penalty along with interest thereon, inter-alia, by attachment and sale of movable and immovable properties.

43. Pursuant to the direction of the Hon'ble SAT in its Order dated July 01, 2020, in Misc. Application No.159 of 2020 in Appeal No.103 of 2020, this Order shall come into force only upon the disposal of the said Appeal by the Hon'ble SAT.

44. A copy of this order shall be forwarded to the Noticee immediately.

Date: September 22, 2020 **G. MAHALINGAM**

Place: Mumbai **WHOLE TIME MEMBER**

SECURITIES AND EXCHANGE BOARD OF INDIA