WTM/GM/MIRSD/ 30 /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 ICRA LIMITED [SEBI Registration No. IN/CRA/008/15]

Background

1. ICRA Limited ("**ICRA**" / "**Noticee**"), is a SEBI registered Credit Rating Agency ("**CRA**"), having its registered office at 1105, Kailash Building, 11th Floor, 26 Kasturba Gandhi Marg, New Delhi 110 001. The equity shares of the Noticee are listed on BSE Limited ("**BSE**") and National Stock Exchange of India Limited ("**NSE**").

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

   c. Failure to consider latest financials in the rating committee note presented on October 27, 2017

4. In view of the above, SEBI initiated adjudication proceedings against ICRA 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 ICRA in the matter .

5. The Adjudicating Officer ("**AO**") vide AO order no. SS/AS/2019-20/6280 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 the penalty imposed by the 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 SEBI (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 19, 2020, submitted reply to the SCN. Gist of submissions made therein is given below:

   a. The AO order has erroneously found ICRA guilty of alleged violation and imposed excessive penalty on erroneous grounds and recorded baseless finding against ICRA.

   b. ICRA was constrained to file an appeal before Hon'ble Securities Appellate Tribunal ("**SAT**") seeking to set aside the AO order as SEBI/AO:

      i. Ignored /misconstrued the contentions of the Notice;

      ii. Attempted to re-write the regulations by applying erroneous principles of interpretation;

      iii. Imposed obligations on the Noticee, which are not mandated by law; and

      iv. AO assessed the ratings on merits, contradicting his own findings that credit ratings has not been reassessed on merits.

   c. The findings of the AO which were sought to be relied upon in the SCN itself were under challenge as being erroneous, baseless and disputed and hence, there were no grounds for exercising power under Section 15-I(3) of the SEBI Act.

Scope of Section15-I(3) of the SEBI Act, 1992

d. The power granted by parliament by way of section 15-I(3) is only to enhance the penalty where it is felt that the order passed by an AO is erroneous and that such an error would not be in the interest of securities market.

e. The SCN may only deal with such portion of the findings in the AO order, where there has not only occurred an error but also the error is of such nature that the decision itself becomes one that is against the interest of the securities market. When these two conditions are met, SEBI may call for the record and assess the facts and circumstances and if at all considered necessary, enhance the penalty imposed.

f. The jurisdiction cannot be lightly invoked and used to deal with every situation where a different view is possible. Nothing contained in the SCN justifies reopening a closed quasi-judicial determination of fact and law where in fact a substantial penalty has been imposed. The SCN is fundamentally flawed and without jurisdiction since it merely seeks to re-open the case without anything to show as to what is erroneous, and how such error in the AO order is against the interest of the securities market.

g. Section 15-I(3) of the SEBI Act is a replica in substance, of section 263(1) of the Income Tax Act, 1961. This pari materia provision has been repeatedly considered both by Hon'ble High court and by Hon'ble Supreme Court, and these decisions would show how SEBI must not use Section 15-I(3) lightly.

h. The intention of the legislature is clear that only in the event that an order is erroneous and the order is against the interest of the revenue, can the revisionary jurisdiction under section 263 be invoked.

i. In the context of the Income Tax Act, 1961, section 263(1) has been held to be applicable when there is a finding to the effect:

   i. That the order is passed without making inquiries or verification which should have been made;

   ii. That the order is passed allowing any relief without inquiring into the claim;

   iii. That the order has not been made in accordance with any order, direction or instruction issued by the Board under section 119; or

   iv. That 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.

j. In the present case, none of these aforesaid features taint the AO order, for the jurisdiction under section 15-I(3) to be invoked.

k. Hon'ble Supreme Court of India, endorsing the views of various High Courts has laid down the following propositions which would apply to SEBI and the AO orders:

i. The order of the AO must not only be erroneous but must also be "prejudicial to the interest of" the securities market. If either of these two features is absent there can be no recourse to the jurisdiction.

ii. Each and every type of mistake or error, if any, committed by the Learned Adjudicating Officer cannot lead to invocation of this jurisdiction. An incorrect assumption of facts or an incorrect application of law would be necessary, or the error should be in the nature of violation of natural justice or be tainted by non-application of mind.

iii. The phrase "prejudicial to the interest of" is not an expression of art and cannot be equated with simple reference to loss of revenue. Every loss of collection of penalty as a consequence of the Learned Adjudicating officer's order would not tantamount to prejudice to the interest of the securities market.

iv. If the Learned Adjudicating Officer were to adopt one of multiple courses permissible in law, or where two views are possible and the Learned Adjudicating Officer has taken a view with which the Learned Whole Time Member does not agree, such a position would not tantamount to an erroneous order that is prejudicial to the interest of the securities market, for the jurisdiction to be invoked.

v. The jurisdiction under section 15-I of the SEBI Act is a revisional jurisdiction with inherent limitations.

vi. An order by the Learned Adjudicating Officer should not be interfered with only because another view is possible.

vii. The supervisory and revisionary jurisdiction under section 15-I(3) of the SEBI Act is not a license for superior officers to force or influence the order that the Learned Adjudicating Officer may pass.

viii. Section 15-I(3) of the SEBI Act does not visualise a power to substitute the judgment of the Learned Whole Time Member for the judgment of Learned Adjudicating Officer to show that a wrong law was applied or an incomplete interpretation was involved.

ix. Section 15-I(3) of the SEBI does not confer an unbridled and arbitrary power to the revising authority to start re-examination and fresh enquiries in a concluded matter. The decision to invoke the provision is a very important one and cannot be based on the whims and caprice of the decision making authority.

x. Merely because the Learned Whole Time Member may have a view that a better assessment of issue could have been framed, the provision of section 15-I(3) of the SEBI Act cannot be invoked.

l. Thus, the power under section 15-I(3) is granted by the parliament only to be exercised where it can be held that the order passed by an Adjudicating Officer is erroneous and that such an error would not be in the interest of the securities market.

Then and only then, and that too, after consideration of the merits, an order enhancing penalty may be imposed.

m. The said jurisdiction cannot be invoked for any and every error or mistake of the AO. Neither can it be invoked only because the revisionary authority has a different view. If the AO has decided the matter within the confines of the law and by taking all the relevant factors into consideration, the revisionary authority does not have the jurisdiction to modify it. The AO order is clearly within the confines of the law – there is no error of law that taints the AO order, and there is no scope of ruling that the AO order is against the interest of the securities market.

n. The key aspect of the section 15-I(3) is that the revisionary authority's jurisdiction is not an appellate jurisdiction and only comes into action when there is an error that will also adversely affect the interest of securities market.

o. In the present case, the AO has taken into account all aspects relating to the allegation and responses provided by the Noticee and has imposed a substantial penalty of Rs. 25,00,000. The SCN may only deal with such portions of the finding of the AO order, when pursuant to an erroneous decision which is against the interest of securities market, the penalty imposed is considered inadequate. The provision is not at all a license to tamper with the AO order because a different view of a higher penalty is possible.

p. There is nothing contained in the SCN that demonstrates how SEBI has come to an opinion that the penalty imposed is insufficient and higher penalty should be imposed as it hurt the interest of the securities market. Without that foundational facet being addressed, since SEBI seeks to reopen closed quasi-judicial determination of the fact and law, it is evident that a new view is simply sought to be substituted for the view set out in the AO order. Such an approach is not tenable or sustainable.

q. Therefore, the SCN is totally flawed and without jurisdiction in relation to allegations where there is a clear-cut finding of there being no violation at all, since section 15-I(3) only comes into operation where SEBI's belief is that the penalty imposed is inadequate.

No Basis to Enhance the Penalty Under Section 15-I(3) of the SEBI Act

r. The said provision is not intended for SEBI to 'enhance' the penalty without stating which operative part of the order was erroneous. Section 15-I(3) is not intended to replace the wisdom/discretion of the AO in proposing enhancement of penalty.

s. In the present case, the basis for enhancement of penalty is stated by SEBI in paragraph 4 of the SCN in the following words:

"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 loss to the investors."

t. The aforesaid allegation was considered by the AO and thereafter the penalty was levied. The SCN does not provide how the AO Order is erroneous to that extent. The SCN completely ignores the fact that the AO Order categorically said that there are no allegations of mala fide against ICRA and does not take the same as a mitigating factor in considering whether there is any basis to enhance the penalty. Further, nothing in the SCN deals with the factors that should be taken into consideration while adjudging the quantum of penalty or enhancement of penalty, including as set out in Section 15 – J of the Act.

u. Further, as per Section 15-I(3), the penalty can be enhanced only when the AO Order was erroneous to the extent it was not in interests of the securities market.

Scheme for investor protection was not breached by the Noticee

v. It is denied that conduct of ICRA resulted in loss to the investors or that the scheme for protection of investors was breached. The AO Order and the SCN wrongfully noted that ICRA failed to exercise its duty to the investors at large by not downgrading the ratings of NCDs of IL&FS. The same has been challenged in the Appeal filed before SAT.

w. The purpose of promoting the interests of the investors as stipulated in the SEBI Act, is rooted in its disclosure-based regime wherein the investor is to be disclosed with all the relevant information to enable the investor/public to take an informed decision

on whether to invest in any security. The same is also reflected in the Regulations in, inter alia, the following manner:

i. Regulation 18 requires the credit rating agency to disclose information relating to the rationale of the ratings, which should cover an analysis of the various factors justifying a favorable assessment, as well as factors constituting a risk, to enable the investor to take his own decision.

ii. Further, Regulation 18 mandates that the investor must be disclosed that the rating is not a recommendation to buy, hold or sell securities, so as to caveat the investor/public that they must undertake their own diligence before investing in such securities.

iii. Additionally, credit rating agencies are mandated to disclose the rating methodology and the performance of their ratings over a period of time to enable the investor/public to take a decision on the extent to which they would want to incorporate the rating read together with the rationale in their own assessment.

x. However, no violation of Regulation 18 or disclosure norms as discussed above has been alleged against the Noticee.

y. Further, the SEBI (CRA) Regulations do not provide as to when ratings should be downgraded but require that to enable the investor to take an informed decision, the requirements as provided in Regulation 18 be complied with. It is no one's case that

ICRA failed to disclose the credit risks to the investors and failed to inform them that the rating is not a recommendation to deal in the rated securities. Neither the First SCN, nor the AO Order or even the instant SCN, have considered the duty of an investor to go through the rating rationale and read the risks disclosed to correspondingly undertake his own diligence before taking an investment decision. Further, it has not been shown how the duty of an investor to conduct his own diligence was impaired by the rating rationale, when the rationale had disclosed to the investor the risks involved, as noted even in paragraph 60 of the AO Order.

z. All holders of NCDs issued by IL&FS were institutional investors and are required to do their own diligence before investing in any security. Further, neither the First SCN, nor the subsequent AO Order or even this instant SCN, allege a violation of clause 1 of the code of conduct in schedule III of Regulations, which states that the credit rating agencies shall make efforts to protect the interest of the investors.

aa. In such a case, SEBI had no basis to state that ICRA had violated any duty to the investors and has no basis to levy/compute/enhance penalty. In view thereof the instant SCN goes beyond the scope of the show cause notice dated December 17, 2018 and is therefore, irregular / illegal use of jurisdiction. On this ground alone, the SCN should be withdrawn.

Conduct of ICRA did not impair orderly and healthy growth of securities market

bb. It is denied that ICRA failed to anticipate the mounting of credit risks of the issuer and place ratings accordingly to alert the market in advance, which resulted in loss to the investors. In this, regard, paragraph 60 of the AO Order itself states that ICRA had shown its concern regarding the deteriorating financial factors on continuing basis in rating rationales, but it had not acted upon the same diligently, by downgrading the rating. The AO Order further relies upon parameters from consolidated balance sheet of IL&FS, comments of ICRA in its rating reports and the credit risks discussed in the rating rationales to come to the said conclusion. However, with the benefit of hindsight, the AO Order in paragraph 61 dismisses the strengths that ICRA had incorporated into its analysis while formulating the rating, without any basis.

cc. The AO Order and the SCN failed to consider the submissions of ICRA in its reply to the First SCN and aide memoire submitted during the course of hearings before the adjudicating officer, on October 11, 2019, which are also a part of the records of the adjudication proceedings. The AO order and the SCN ignore the submissions of ICRA that the element of prognosis is inherent in a rating.

dd. The rating provided by ICRA was an independent 'opinion', on the likelihood of IL&FS to reimburse the principal and pay the interest on its NCDs on the due dates in the future. To formulate such opinion, the analysts and the rating committee were

required to consider various factors, some of which represent credit strengths and other factors which represent credit challenges.

ee. Additionally, the rating process required a balance of publishing timely ratings that are predictive of an issuer's credit profile while avoiding precipitous rating changes. Consequently, the analysts and the rating committee balanced such conflicting factors and exercised their independent professional judgment, by relying on, amongst other things, their past experience, to apply these various factors to the available information, in the specific context of that point in time and consider likely outcomes.

ff. As a result of which, the element of prognosis is inherent in a rating and even the highest rated instrument carries certain degree of credit risks. Different market commentators, or even different credit rating agencies, may approach the same set of facts with their own methodologies and arrive at different opinions, which are incorporated by the investor into his own analysis.

gg. Merely because two opinions are possible, one cannot be considered to be vitiated in law as wrongful, with the benefit of hindsight. Since formulation of rating entails a balancing exercise between various conflicting factors, such as credit strengths and challenges and between publishing timely ratings, while avoiding precipitous rating changes, weightage given by experts to different factors to arrive at an opinion in exercise of bona fide, conscious and independent professional judgment, cannot be called into question with benefit of hindsight.

hh. The Regulations also take care to ensure that the expression of opinion by way of a rating is not questioned over merits. It is only the rating process that is regulated. Thus, Regulation 29(4) provides a bar on assessment of the ratings on merit. The AO Order and the SCN have completely disregarded the same in finding that ICRA allegedly failed to anticipate the mounting credit risks and place the ratings accordingly to alert the market in advance, which resulted in loss to the investors.

ii. The rating given was not a guarantee of performance on the NCDs, but an opinion on the likelihood of IL&FS of repaying the debt in the future. ICRA had always disclosed to the investors the risks to the credit profile and did not impair their right to take their own decision. Thus, there is no basis to find fault with ICRA by stating that ICRA failed to anticipate the mounting credit risks and place the ratings accordingly to alert the market in advance, which resulted in loss to the investors. Consequently, any finding of violation by ICRA is not maintainable and hence no penalty is leviable on this count.

jj. The AO Order and the SCN have not considered, inter alia, the nature of work of a credit rating agency, the rating process, the relevant expertise of a credit rating agency and the professionals involved, and the limitations to its role and thus has failed to construe the implications on 'orderly and healthy growth of securities market' in its correct perspective.

kk. The SEBI (CRA) Regulations have balanced various complex factors and do not provide that ICRA is to investigate each and every information received and relied upon by ICRA, which is also beyond the expertise of ICRA. The SEBI (CRA) Regulations however provide for cooperation from various stakeholders, such as the client, auditors, bankers, debenture trustees etc. to enable ICRA to arrive at a fair and appropriate ratings, and the appropriateness of such ratings cannot be assessed in terms of Regulation 29(4).

ll. The SCN further notes certain findings of the AO Order in paragraph 3 of the SCN, however the said findings are under challenge by way of the Appeal as the same are erroneous. The SCN does not state how the exercise of discretion is erroneous/ additional factors that were not considered by the AO, such that it warrants enhancement of penalty. Further, the SCN completely ignores the fact that the AO Order categorically said that there are no allegations of mala fide against ICRA and does not take the same as a mitigating factor in considering whether there is any basis to enhance the penalty.

mm. In paragraph 3, the SCN notes that the AO Order had observed that a credit rating agency plays a crucial and important catalytic role in fostering the growth of capital markets as it, inter-alia, is a prerequisite for bond market access and may be the minimum requirement for listing a corporate debt on the stock exchange. However, the SCN fails to consider that the context of this observation in the AO Order was

to use the 'functional role' of the credit rating agencies as a basis to disregard plain meaning of the Regulations.

nn. SEBI, in formulation of the SEBI (CRA) Regulations, had balanced the above consideration with, inter alia, the nature of work of a credit rating agency, the rating process, the relevant expertise of a credit rating agency, and the professionals involved and the limitations to its role and hence imposed the obligations as is reflected from a plain reading of the SEBI (CRA) Regulations. Thus, the AO Order ignored that the Regulations intended to be the exhaustive and complete code for determining the regulatory rights and obligations of credit rating agencies. The action of the adjudicating officer in holding the Appellant responsible for the alleged violation on this basis is, therefore, illegal and does not justify a levy of penalty.

oo. There was no alleged violation by ICRA and that the levy of penalty in AO Order is itself erroneous and excessive. Any levy / computation / enhancement of penalty on ICRA, must be on the basis of conduct of ICRA and how any violation of CRA Regime had directly affected the interests of securities market. Thus, the above mentioned observation of SCN cannot be the basis for enhancement of penalty.

pp. The SCN in paragraph 3, inter alia, notes that AO Order had observed that the default had taken place due to lethargic indifference and needless procrastination and the laxity of the credit rating agencies. Further, the SCN notes the AO Order's

observations that reliance of investors and regulators on ratings outweighs any lack of due diligence by the credit rating agencies. In this regard, it is submitted that:

i. The AO Order had made baseless observations that the default had taken place due to lethargic indifference and needless procrastination. While rating the NCDs issued by IL&FS, ICRA exercised its best professional judgment and formed its bona-fide / conscious opinion in accordance with the applicable rating criteria as well as Regulation 24(7) and paragraph 4 of the code of conduct in the Regulations and there were no material deviations or inconsistencies from the processes and requirements mentioned therein. ICRA had never acted either in reckless disregard to its stated methodology or under improper motivation or mala-fide intention in the expression of opinion and rating of NCDs issued by IL&FS. ICRA had materially adhered to the CRA Regime in its actions while rating any instrument or dealing with any issuer. It is again summarised that the scope of a formation of an opinion on creditworthiness is not at all similar to any audit, much less statutory audit or internal audit, nor can two opinions of varying CRAs be reflective of their bona-fide in light that both can arrive at varying opinions based on the same facts. The facts have to be seen from the standpoint of when the rating was given. The rationale of rating by ICRA is based on the publicly disclosed information on multiple forums including the stock exchanges, publicly available and auditor cleared financials of IL&FS and its affiliates, its history and representations of

IL&FS not being contradicted by any stakeholder or any publicly disclosed information.

ii. While the AO Order and the SCN have taken into consideration how the investor reacts to a rating, however it has not considered how the investor 'ought' to react to a rating, which is not to rely just on the rating itself, but read the rating in conjunction with the rationale and incorporate the rationale in his own diligence before investing in any security. This is also evident by a statutory mandate directed at the investor under Regulation 18. Thus, the same cannot be a basis to levy / compute / enhance the penalty.

qq. The SCN notes in paragraph 3, inter alia, that the AO Order observed that the failure was brazen and grave, considering the role and responsibility of ICRA under Regulations and had defeated the purposes of the Regulations i.e. investor protection and orderly development of the securities market. In this regard, it is submitted that:

i. There is no basis to state that the alleged failure was brazen, as the AO Order itself in paragraph 68 states that there is no allegation of mala-fide against ICRA, which is a mitigating factor to be considered in levy / computation / enhancement of penalty.

ii. The role and responsibility of ICRA had not been considered in the AO Order and in the SCN in its complete perspective, as explained in paragraphs above, as it failed to consider the the nature of work of a credit rating agency, the rating

process, the relevant expertise of a credit rating agency, and the professionals involved and the limitations to its role. Thus, the same cannot be a basis for levy / computation / enhancement of penalty. Further the AO Order, upon consideration of only the 'functional role', has rejected the plain meaning of the Regulations, attempted to re-write the Regulations and imposed obligations on ICRA beyond the Regulations, which is illegal. Thus, the same cannot be a basis to state that the default was grave and to levy / compute / enhance penalty.

iii. It is denied that any alleged default by ICRA had defeated the purposes of the Regulation to protect the investors, as explained in paragraphs above. ICRA had disclosed all risks to the credit profile of IL&FS and had not impaired the right of the investors to take their own investment decision. There are no allegations of breach of Regulation 18 or clause 1 of the code of conduct of the Regulations either.

iv. It is denied that the alleged failure of ICRA had defeated the purpose of orderly development of securities market, as explained above.

Violation of Principles of Natural Justice

rr. The SCN is ambiguous and vague as it does not provide any reasons for basis for invocation of Section 15-I(3) of the SEBI Act, 1992 and is hence vitiated in law.

ss. To provide ICRA with an effective and meaningful opportunity to respond to the SCN, it is required that the SCN must provide the reasons as to how the AO Order is erroneous to the extent it is not in the interests of the securities market and how the circumstances of the case justify enhancement of penalty. In the event a show cause notice is vague and not specific, then the same violates the principles of natural justice. The same has been upheld by the Hon'ble Supreme Court of India in various judgments including CCE v. Brindavan Beverages (P) Ltd., (2007) 5 SCC 388 (Para 13-14).

tt. The SCN does not provide how the exercise of discretion by the adjudicating officer is erroneous to the extent it is not in the interests of the securities market. The SCN only makes a bald statement in paragraph 4 that "S*EBI, after on examining the records of the above mentioned adjudication proceedings, is of the opinion that AO Order is erroneous and it is not in the interests of the securities market*.", without providing the basis of the same.

uu. The SCN must state the nature of the inquiry that had taken place prior to the SCN and findings of such inquiry. A reading of the record of the adjudication proceedings does not amount to an inquiry being conducted. The SCN does not provide as to what inquiry was made to arrive at the erroneous nature of the AO Order. The SCN does not provide what erroneous factors have been considered / other factors that should have been considered while deciding the quantum of penalty in the AO Order. Further, the SCN does not provide the proposed enhanced penalty that SEBI seeks

to levy and how the circumstances of the case justify the levy of the proposed enhanced penalty.

vv. In light of the above, it is contended that the SCN is vague and ambiguous as it provides neither the proposed enhanced penalty nor the circumstances which justify the levy of such enhanced penalty nor the basis for stating that the AO Order is erroneous to the extent it is not in the interests of the securities market. This hampers the Noticee's right to effectively respond to the SCN and does not provide ICRA with a meaningful opportunity of being heard, violating the Noticee's rights under Section 15-I(3) of the SEBI Act. Thus, the same is against the principles of natural justice which vitiates the SCN.

ww. In light of the above, the Noticee submitted that:

i. the instant SCN is not valid since it neither provides the nature of inquiry that was conducted to determine that the order of the AO was erroneous; nor provides the reasons for stating that the AO Order is erroneous to the extent it is not in the interests of the securities market; nor provides the quantum of penalty to be enhanced and how the circumstances of the case justify the same. Thus, it violates the principles of natural justice as it does not provide the Noticee with a reasonable opportunity to reply to the SCN;

ii. the requirements for exercise of power under Section 15-I(3) of the SEBI Act are not being met in the instant case;

iii. the findings of the AO Order and the imposition of penalty are under challenge by way of the Appeal; and

iv. the levy of penalty of Rs.25,00,000 is itself erroneous and excessive.

uu. Thus, the Noticee submitted that there is no basis for exercise of power under Section 15-I(3) and that the SCN be withdrawn / closed.

9. The Noticee was also given an opportunity for personal hearing on June 29, 2020. Somasekhar Sundaresan, Prashant Pakhidey, Yugandhara Khanvilkar and Lakshmi Dwivedi, Advocates representing the Noticee and Amit Gupta and Praman Preet Singh Gujral, authorised representatives of the Noticee, attended the hearing through video conferencing and made oral submissions. Noticee also made additional written submissions vide email dated July 06, 2020. The gist of the said submissions is given below:

a. The SCN itself doesn't make any allegations and only reiterates the findings of the AO Order that are adverse to the Noticee.

b. The reason stated in the SCN for enhancement of penalty has already been considered and recorded *pari materia* in the AO Order in paragraph 64. The SCN does not set out what according to SEBI, is the error in the AO Order, warranting the invocation of this jurisdiction. Consequently, the Enhancement of Penalty SCN is vague and violates the principle of natural justice, which makes it void as it neither provides: (i)

the nature of inquiry that was conducted to determine that the order of the AO was erroneous; (ii) nor provide the reasons for stating that the AO Order is erroneous to the extent it is not in the interests of the securities market; and (iii) nor provides the quantum of penalty to be enhanced and how the circumstances of the case justify the same, in accordance with the principles of Section 15J of the SEBI Act.

c. The jurisdiction under Section 15-I(3) of the SEBI Act, is not a jurisdiction for replacing one view of the penalty amount with another or to adjudicate on merits when the decision in the AO Order on merits are in line with the SCN.

d. Section 15-I(3) of the SEBI Act is in pari materia with Section 263(1) of the IT Act, 1961 and numerous judgements of Hon'ble Supreme Court and High Courts have held that this jurisdiction is applicable only when there is a material error and the error is prejudicial to the interest of the securities market. Following observations of the courts were also highlighted in the reply:

   i. Each and every type of mistake or error, if any, committed by the Learned Adjudicating Officer cannot lead to invocation of this jurisdiction. An incorrect assumption of facts or an incorrect application of the law would be necessary, or the error should be in the nature of violation of natural justice or be tainted by non-application of mind.

   ii. The phrase "prejudicial to the interest of" is not an expression of art and cannot be equated with a simple reference to loss of revenue. Every loss of revenue as a

consequence of the Learned Adjudicating Officer's order would not tantamount to prejudice to the interest of the revenue.

iii. If the Learned Adjudicating Officer were to adopt one of multiple courses permissible in law, or where two views are possible and the Learned Adjudicating Officer has taken a view with which the Learned Whole Time Member does not agree, such a position would not tantamount to an erroneous order that is prejudicial to the interest of the securities market, for the jurisdiction to be invoked.

iv. An order by the Learned Adjudicating Officer should not be interfered with only because another view is possible.

v. The supervisory and revisionary jurisdiction under Section 15-I(3) of the SEBI Act is not a license for superior officers to force or influence the order that the Learned Adjudicating Officer may pass.

vi. Section 15-I(3) of the SEBI Act does not visualise a power to substitute the judgment of the Learned Whole Time Member for the judgment of Learned Adjudicating Officer who passed the order. There must be some material on record to show that a wrong law was applied or an incomplete interpretation was involved.

vii. Merely because the Learned Whole Time Member may have a view that a better assessment of issues could have been framed, the provisions of Section 15-I(3) of the SEBI Act cannot be invoked.

viii. The jurisdiction under Section 15-I of the SEBI Act is a revisional jurisdiction with inherent limitations.

ix. Section 15-I(3) of the SEBI Act does not confer an unbridled and arbitrary power to the revising authority to start re-examination and fresh enquiries in a concluded matter. The decision to invoke the provision is a very important one and cannot be based on the whims and caprice of the decision making authority.

e. The SCN is in complete agreement with the AO Order and the findings of the said AO Order are under challenge in the Appeal filed before Hon'ble SAT.

f. The SCN is silent of how the AO Order is prejudicial to the interests of the securities market.

g. The provision is not at all a license to tinker with the AO Order because a different view may be harboured on the same findings about the quantum of penalty to be imposed.

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:

10. 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."

11. In this connection, the Noticee had raised two main preliminary objections – (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 relied on various judgments, for this position as well as to explain the scope of revisionary powers, such as Malabar Industrial Co. Ltd. Versus CIT, Kerala State (2000)2

SCC 718; CIT, Shimla Versus Greenworld Corporation, Parwanoo (2009) 7 SCC 69, CIT versus Gabriel India Ltd. (1993)203 ITR 108 of the Bombay High Court; and CIT versus Arvind Jewellers (2003)259 ITR 502 of Gujarat High Court, to substantiate 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.

12. 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."

13. 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 Adjudicating Officer 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.

14. 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."

15. 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."*

16. 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.

17. 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 12 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

18. 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.

19. 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 that the same violates the principles of natural justice. 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 said SCN.

20. 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.

21. 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.

22. 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."*

23. 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.

24. 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.

25. 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:

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

    a. The Noticee has been rating various instruments such as 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 re-affirmed 'AAA' rating to the NCDs issued by IL&FS on March 27, 2018, downgraded the rating to 'AA+' on August 06, 2018 and to 'BB' on September 06, 2018 and further downgraded it to 'D' on September 17, 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 latest financials / Asset-Liability Mismatch ("**ALM**") position of IL&FS, as on June 30, 2017; and

iv. Failing to examine / consider material events and other indicators in time leading to sudden downgrade in CPs issued by IL&FS and IFIN from A1 to A4.

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.

27. As stated at paragraph 25 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 51 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. The Noticee failed to adequately caution the investors regarding the high leverage and delay in implementation of asset monetization plans by IL&FS as it was waiting for further deviations to turn the outlook to negative.*" (Para 52 of the AO Order)

c. "*It is also admitted fact and a matter of record that the borrowings of IL&FS had increased from Rs. 12,122.20 crore on March 31, 2017 to Rs. 13,113.10 crore as on June 30, 2017. However, these figures were not presented by the Noticee to its rating committee in the note presented on October 27, 2017 and were also not disclosed in the Rating Rationale dated November 3, 2017.*" (Para 53 of the AO Order)

d. "*It is also undisputed fact that figures for ALM as on March 31, 2017 was considered by the rating committee of the Noticee in its meeting dated October 27, 2017 instead of considering the ALM figure as on June 30, 2017. In fact the Noticee did not make an effort to seek ALM figure as on June 30, 2017 from IL&FS when it provided on September 20, 2017 the ALM figures as on March 31, 2017. Considering the fact that ALM figure as on June 30, 2017 would have been the*

most important point of analysis as the business of NBFCs/ CICs depends on their ability to maintain a comfortable asset – liability position across various buckets, such conduct shows glaring lack of prudence and due diligence." (Para 53 of the AO Order)

e. "*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 the issuer.*" (Para 60 of the AO Order)

f. "*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 68 of the AO Order)

28. 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.

29. 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.

30. 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 of the SEBI (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

31. 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 ratings 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.

32. A 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."

33. 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 and the Noticee's Contentions

34. 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 SEBI (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.

35. Regulation 18 of the SEBI (CRA) Regulations mandates the disclosure of the Rating Definitions and Rationale to the public. The Noticee has attempted to use the mandate of disclosure contained in Regulation 18 along with the mandatory disclaimer that should accompany every rating (that the ratings do not constitute a recommendation to buy, hold or sell any securities), as a shield to defend the allegations contained in the original SCN. Without getting into the merits of such allegations, it is clarified that the disclosure has been mandated with the idea of giving the public investors a view about the rating definition applicable to the rating symbol assigned by the CRA to the particular debt instrument/ product. This provision, in no way, would help a CRA to cover up its failure to assign a fair and appropriate rating symbol to a particular product at the particular point in time. The same logic applies to the disclosure of the rationale of the ratings as well. Mere disclosure of the rationale does not justify errors in the reasons. The object of the SEBI (CRA) Regulations is to ensure that proper rating processes are put in motion by the rating agencies who are otherwise required to be professionally competent for this job and mandated to express their opinion about the product /instrument through standard symbols, as defined by SEBI in its circulars. The further contention of the Noticee that the credit rating is an opinion and not a guarantee on the ability of the IL&FS to reimburse the principal debt with interest is self-defeating, to say the least. It is nobody's case that credit rating is a guarantee. At the same time, it needs to be emphasized that credit rating is an opinion of the CRA, which is expected to be crystallized after a thorough analysis of the financial position of the entity, applying the highest standards of due diligence. In this context, it is relevant to state that the AO has analysed and brought out the pitfalls in the

credit rating processes adopted by the Noticee in Para Nos. 49 to 66 of his order dated December 26, 2019, while arriving at such opinion. The narrow time span within which the consecutive downgrading of the credit rating happened is also illustrative of the defects in the rating processes, even assuming that it is an opinion. I further note that the provision in Regulation 24 (9) mandating prior information to the Board by a CRA before changing the "rating definition" or the "structure for a particular rating product" is also of no avail to the CRA to justify an erroneous assignment of rating. If the contentions of the Noticee were to be accepted, the very purpose of credit rating of securities prior to their public issue becomes an empty, meaningless and a futile formality, thus defeating the purpose of the SEBI (CRA) Regulations.

Critical Role of Institutional Investors

36. 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.

37. 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

38. The Noticee has been rating the 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 and CPs amounting to Rs.4750 crore issued by IL&FS and 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 05, 2018, were abruptly downgraded to default grade on September 17, 2018, i.e. within a gap of just 43 days.

39. Another major argument put forth by the Noticee was that the conduct of the Noticee did not impair the orderly and healthy growth of securities market and the ratings given was not a guarantee of performance on the NCDs, but an 'opinion' on the likelihood of IL&FS of repaying the debt in the future. I note that similar argument was put forth by the Noticee before the AO. The AO, while underscoring the importance of role played by

the CRAs in the securities markets, has rightly observed that "..*These 'standard symbols' are of considerable significance as the investors in the corporate bond market rely largely on those 'rating symbols' which are assigned by the professional 'credit rating agencies' after a qualitative and independent evaluation of the creditworthiness of the instrument and the issuers thereof*…". 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.

40. The Noticee has contended that the scope of regulatory/supervisory jurisdiction of SEBI is confined to the credit rating processes followed by the CRAs and that SEBI cannot adjudge the appropriateness of the ratings. The Noticee has relied upon Regulation 29 (4) of the SEBI (CRA) Regulations to substantiate the said statement. Regulation 29 provides for powers of SEBI in inspection and the same are not relevant in the context of quasi-judicial proceedings. I now proceed to explain the specific reasons as to why the penalty imposed by the AO is required to be revised upwards.

Reasons for Enhancement of Penalty

41. 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 17, 2018, the outstanding amount of securities so rated by the Noticee amounted to Rs.11,725 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 markets 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 43 days has completely changed the risk perception of the corporate bond market.

g. The Board needs to safeguard market integrity, and when scams of this size occur, which questions and challenges the regulatory and supervisory framework put in place with respect to CRAs, it is but imperative, to subject the conduct of CRAs to tight scrutiny and restore investor confidence by enhancing the penalty.

42. 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

43. 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.

44. 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 receipt of this order. 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)	

In the event of failure to pay the said amount of penalty within 45 days of the receipt 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.

45. 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