WTM/GM/MIRSD/31 /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 CARE RATINGS LIMITED [SEBI Registration No. IN/CRA/004/1999]

Background

1. CARE Ratings Limited ("**CARE**" / "**Noticee**"), is a SEBI registered Credit Rating Agency ("**CRA**"), having its registered office at 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off. Eastern Express Highway, Sion (East), Mumbai - 400022. 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 place the rating under Credit Watch.

   c. Rapid rating downgrade on CPs of IFIN by CARE.

4. In view of the above, SEBI initiated adjudication proceedings against CARE 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/2019-20/6281 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 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. Noticee, vide letter dated February 24, 2020, submitted reply to the SCN. Gist of submissions made therein is given below:

   a. There was no failure on the part of the Noticee to anticipate credit risks of any issuer company or to exercise due diligence and the findings in the AO Order are erroneous and unsustainable and no penalty ought to have been imposed on it.

b. The jurisdiction under section 15-I cannot be invoked as a matter of appellate review and the revision jurisdiction of section 15-I(3) is not at all available in the facts of the case.

c. The power under section 15-I(3) is granted by the parliament only to enhance the penalty 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.

d. 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.

e. 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 to the AO order being against the interest of the securities market.

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

g. From the reading of the said Section 263(1) of the IT Act, 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.

h. In the context of the IT Act, 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 assesse, rendered by the jurisdictional High Court or Supreme Court in the case of the assesse or any other person.

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

j. Hon'ble Supreme Court of India, endorsing the views of various High Courts, has laid down the following propositions in the context of Section 263(1) of the IT Act, which would also apply to SEBI and the AO order as follows:

i. The order of the Learned Adjudicating Officer 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 revenue as a consequence of the Learned Adjudicating officer's order would not tantamount to prejudice to the interest of the revenue.

iv. If the Learned Adjudicating Officer were to adopt one of multiple course 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.

k. From the above, it is seen that the power under section 15-I(3) is granted by the parliament only 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, penalty may be imposed.

l. The said jurisdiction cannot be invoked for any and every error or mistake of the officer. Neither can it be invoked only because the revisionary authority has a different view. If

the Learned Adjudicating officer 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 clearly is 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.

m. 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.

n. In the present case, the Learned Adjudicating Officer has taken into consideration all aspects relating to the allegation and responses provided by the Notice 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.

o. There is nothing contained in the SCN that demonstrate 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 foundation facet being addressed, since SEBI seeks to reopen closed quasi-judicial determination of the fact and law, it is evident that a view is simply sought to be substituted for the view set out in the AO order. Such an approach is not tenable or sustainable.

p. Therefore, the SCN is totally flawed and without jurisdiction in relation to allegation 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.

q. In view of the above, the Noticee submitted that:

i. the Noticee is aggrieved by the findings in the AO Order and is in the process of challenging the same by way of an appeal before the Hon'ble Securities Appellate Tribunal ("**SAT**"). Therefore, a second proceeding in the matter to enhance the penalty is premature;

ii. the SCN be withdrawn and the present proceedings be terminated;

9. The Noticee was also given an opportunity for personal hearing on June 29, 2020. Somasekhar Sundaresan, Joby Mathew and Yugandhara Khanvilkar, Advocates and Navin Jain and Arun Kumar, authorised representatives of the Noticee attended the hearing and made oral submissions. Noticee also made additional written submissions vide letter dated July 07, 2020. The gist of additional submissions made is given below:

a. AO cannot sit on judgement on the appropriateness of the ratings assigned by the Noticee.

b. Credit Rating is an opinion and "excessive reliance placed" as alleged in the SCN is a subjective term.

c. SEBI (CRA) Regulations require the clients to cooperate and provide required information to the CRAs and require CRAs to rely on the information so provided.

d. Scope of inspection under the SEBI (CRA) Regulations does not cover appropriateness of the assigned ratings and hence, the foundation of the initial SCN itself is erroneous.

e. Review of orders shall be done only if the order is erroneous and such error affects the interest of the investors in the securities market and cannot be done without conducting an enquiry.

f. No material error in the AO Order has been pointed out in the SCN and the instant case does not qualify for the review.

g. 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.

h. Market perception of penalty amount cannot be factored into while passing the order for penalty amount.

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, 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 Noticee is in the process of challenging the AO order is itself before the SAT. The Noticee also 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 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.

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. 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.

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. Another issue raised by the Noticee is that it is in the process of challenging the AO Order, which is sought to be relied upon in the SCN itself and hence, a second proceeding in the matter would be premature. I find that there is no regulatory or statutory bar on initiation or continuation of the review process as envisaged in Section 15-I(3) of the SEBI Act, due to pendency of any appeal against the original AO Order. I note that the appeal being filed by the Noticee against the AO Order has not reached any conclusion nor any interim directions has been issued by SAT in the matter. In view of the above, I do not find any merit in the Noticee's argument that there are no grounds for exercising power under Section 15-I(3) of the SEBI Act.

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 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 May 09, 2018, downgraded the rating to 'AA+' on August 16, 2018 and to 'BB' on September 09, 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 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. "*.When the Noticee was informed by IL&FS about the approval of the said right issue by IL&FS, it has not put any effort to verify the same from the stock exchange. When IL&FS made the claim about its said right issue and Specific Asset Disinvestment plan to reduce its overall debt by ₹30,000 crores on August 29, 2018 via a disclosure on its web site and informed the Noticee about the same, the Noticee again did not verify the truth and veracity from the disclosures made on stock exchange.*"(Para 48 of the AO Order)

b. "*In this regard, I note that, though the Noticee claimed that as per the scheduled maturity IL&FS could have repaid the CPs, however, it is an admitted fact that not only IL&FS failed to repay the CPs on September 14, 2018, but also defaulted in the interest payments on its NCDs on various dates i.e. September 17, 21, 26 and 29, 2018. It shows that being a reputed 'credit rating agency' with years of experience in the field of rating, the Noticee failed in assessing the ALM position of IL&FS as a group. Thus, I note that the Noticee has lacked 'due diligence' in assessing the ALM situation as alleged in the SCN.*" (Para 49 of the AO Order)

c. "*..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 50 the AO Order)

d. "*In view of the above, I note that financial parameters of the IL&FS and its group companies especially, short term borrowings, debt equity ratio, current maturities of long term debt, operating profit, monetization of assets etc., were not as conducive or healthy as assumed by the Noticee in its rating report or rating rationale.*" (Para 54 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 56 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 65 of the AO Order)

28. As noted from the above, 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 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 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.

32. 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."

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, 1999

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. The object of the 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 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. 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 CRA Regulations.

Critical Role of Institutional Investors

35. 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.

36. 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

37. 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.8,000 crore and CPs amounting to Rs.3,250 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 highest rating by the Noticee and which continued to be so till August 15, 2018, were abruptly downgraded to default grade on September 17, 2018, i.e. within a gap of just 33 days.

38. 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 bear an effect on the issuers' ability to access capital.

39. 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

40. 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.20,942 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 its steep downgrade by the Noticee in a matter of 33 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.

41. 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

42. 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 violation established as mentioned above, having found the AO Order dated December 26, 2019 as erroneous and 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.

43. 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 forwarding details and confirmations 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)	

44. 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.

G. MAHALINGAM

PLACE: MUMBAI **WHOLE TIME MEMBER**

DATE: September 22, 2020 **SECURITIES AND EXCHANGE BOARD OF INDIA**