SEBI's 'capital' punishment to NSE, an unprecedented move

Moot point is whether the bourse deserves a penalty if it hasn't committed fraud

ASHISH RUKHAIYAR

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

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

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

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

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

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

Lot at stake with NSE

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

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

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

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

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

"SEBI itself is saying that there is no fraud in this matter, but then goes on to pass a disgorgement order," said a former SEBI official wishing not to be named.

Bad precedent

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

> SEBI has tried to balance various interests
>
> SUMIT AGRAWAL
> Founder, Regstreet Law Advisors

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

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

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

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

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

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

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

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

Way forward

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

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

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

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

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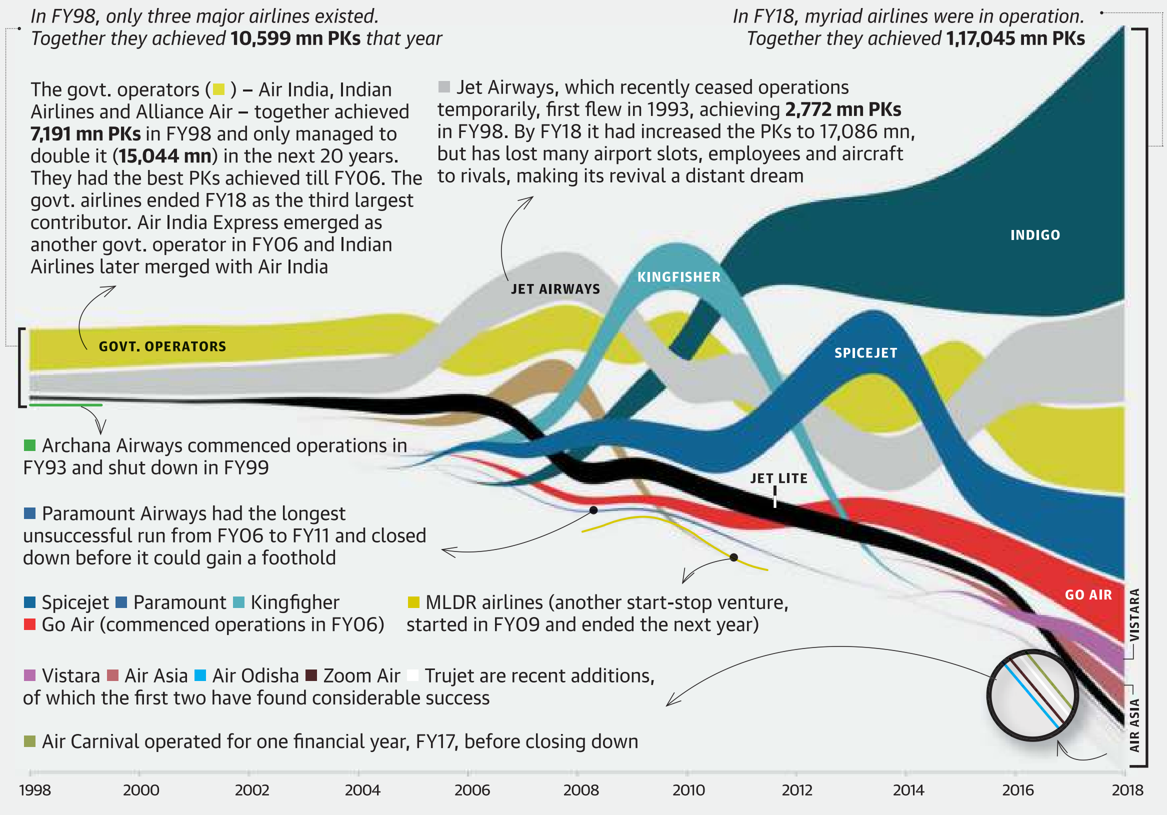
Running into headwinds

The aviation industry has hit an airpocket due to spiralling fuel costs and competitive fares. This visualisation, where the airlines are differentiated by coloured bands, shows the state of players in the industry across time frames. The bigger the band, the more the passenger-kilometres (PK) achieved. One PK is achieved when one passenger is carried for one kilometre. By **Vignesh Radhakrishnan**



■ Air Sahara, which later became JetLite after the buyout by Jet Airways in 2007, started off light with just 626 mn PKs in FY98 and stayed below the radar for the most part, but is still hanging in there

■ Indigo grew rapidly and went on to lead the pack in FY11, gaining directly from Kingfisher's downfall. As of FY18, it has 47,900 million PKs, 2.8 times its nearest competitor, Jet Airways

■ Air Deccan, which was India's first low-cost carrier, reached its peak in FY08, becoming the third biggest airline, after debuting in FY04. It merged with Kingfisher Airlines in FY09

■ GoAir is the fifth-biggest airline in terms of PKs achieved as of FY18. It has attained steady growth over the years

■ SpiceJet progressed rapidly and is the fourth-biggest airline in terms of PKs as of FY18. It peaked in FY13 and FY14. After a temporary hiccup in FY15 and FY16, it flew back into competition recently

SOURCE: DGCA

GRAPHIC: KARTHICK S.T

INTERVIEW | DIPAK HAKSAR

'We expect prices to rise, over time'

Rates yet to achieve potential in upper upscale, luxury segments: ITC Hotels' MD

INDRANI DUTTA

ITC's hotel portfolio comprises about 10,000 keys across four brands – ITC Hotels, WelcomHotel, Fortune and WelcomHeritage – with about 100 properties in over 70 destinations. These cater to various segments ranging from superlative luxury, leisure, heritage hospitality to branded first class, full service business hotels.

ITC Hotels is aiming to scale up room capacity, and is looking at a significant expansion over the next 3-5 years, says **Dipak Haksar**, *CEO of ITC Hotels and WelcomHotels. Excerpts from an interaction:*

What were the main drivers for your growth? How does the future look – revenue- and margin-wise?

■ It has been good for ITC's hotels business and we have managed to grow on par with the market. We foresee this trend to continue for the next few years. The growth in yields has been primarily powered by a buoyant retail segment while volumes have evidently been driven by a surge in the MICE-business (meetings, incentives, conferences and events).

What are the hospitality industry trends? Do you see a price correction coming up?

■ While maximum growth has understandably come from the upper upscale and upscale segments, luxury hotels have also shown healthy growth in both demand and rates.

Industry studies have revealed that in most markets, rates have not yet achieved their potential in the upper upscale and luxury segment. Consequently, it is our belief that a gradual upward price correction will be witnessed over the next few years.

How many rooms does ITC have now and what is the projected increase?

■ We currently own and manage close to 10,000 keys across our four brands. Our growth trajectory for the next 3-5 years includes an additional 5,000 rooms across these brands.

Where will these new projects come up? Any new locations being considered?

■ The new hotels will come up in Tier I, Tier II cities and unconventional destinations as well. The ITC Royal Bengal is scheduled for opening in the first quarter of this fiscal. This will be followed by Welcomhotels in Amritsar, Chail, Bhubaneswar, Chennai, Ahmedabad, Katra and the ITC Narmada in Ahmedabad.

What has been ITC's average occupancy rate and how does that compare with industry... Especially ITC Sonar?

■ Occupancies vary from city to city depending on demand-supply dynamics. For us, occupancies have by and large been consistent with the market. The same goes for ITC Sonar too.

Which of your properties contributes the best topline and bottomline numbers?

■ ITC's super premium luxury portfolio is a major contributor to both topline and bottomline figures.

You had once mentioned that the Fortune brand, targeting the mid market to upscale segment was undergoing consolidation...

■ Fortune Hotels will continue to follow a management model, whereas the Welcomhotel brand is being consolidated through a mix of owned and managed properties.

What is the status of the Sri Lanka project?

■ The ITC One Hotel & Residences in Colombo is slated for opening in 2020.

Is ITC looking at any buys or properties to manage?

■ ITC Hotels continues to pursue an aggressive asset-right-led strategy, in line with our vision to be a leading global hospitality player.

'No guarantee that bank privatisation will be a panacea'

'We need to recognise that ownership is just one contributor to governance, and look at pragmatic ways to improve governance across the board'

RAGHURAM RAJAN

BOOK EXTRACT

The banking system is overburdened with non-performing loans. Much of the problem lies in public sector banks, but private sector banks like ICICI and Axis Bank have not been immune.

Some of the malaise comes from a general need to improve governance, transparency and incentives in the system. However, the difficulties in even some private banks suggest that 'simple' solutions like privatising all public sector banks may be no panacea.

At any rate, banking reforms should tackle four broad areas: 1. Clean up banks by reviving projects that can be revived after restructuring debt. 2. Improve governance and management at public sector banks. 3. De-risk banking by encouraging risk transfers to non-banks and the market. 4. Reduce the number and weight of government mandates for public sector banks, and for banks more generally.

Privatise or not?

Is privatisation of public sector banks the answer? Much of the discussion on privatisation seems to make assumptions based on ideological positions.

Certainly, if public sector banks are freed from some of the constraints they operate under (such as paying above the private sector for low-skilled jobs and paying below the private sector for senior management positions, having to respond to government diktats on strategy or mandates, or operating under the threat of CVC/CBI scrutiny), they might perform far better. However, such freedom typically requires distance from the government. So long as they are majority-owned by the government, they may not get that distance.

At the same time, there is no guarantee that privatisation will be a panacea.

Some private banks have been poorly governed. Instead, we need to recognise that ownership is just one contributor to governance, and look at pragmatic ways to improve governance across the board.

There certainly is a case to experiment by privatising one or two mid-sized public sector banks and reducing the government stake below 50% for a couple of others, while working on governance reforms for the rest.

Rather than continuing a never-ending theoretical debate, we will then actually have some evidence to go on.

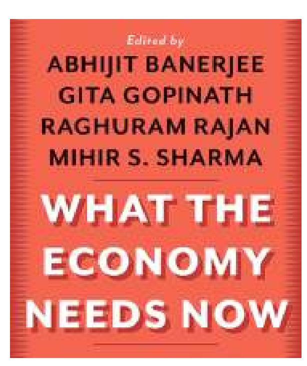
Some political compromises will be needed to allow the process to go through, but so long as the newly privatised banks are not totally hamstrung in their operational flexibility as a result of these compromises, this will be an experiment worth undertaking.

An alternative proposal to improve governance is to merge poorly managed banks with good banks. It is uncertain whether this will improve collective performance - after all, mergers are difficult in the best of situations because of differences in culture. When combined with differences in management capabilities, much will depend on whether the good bank's management is strong enough to impose its will without alienating the employees of the poorly managed bank.

We now have two experiments under way: State Bank has taken over its regional affiliates, and Bank of Baroda, Vijaya Bank and Dena Bank have been merged. The performance of the latter merger will be more informative. Thus far, market responses suggest scepticism that it will play out well. Time will tell.

De-risk banking by encouraging risk transfers to non-banks and the market

Too many risks devolve on to banks, including risks such as that of interest rate volatility that banks elsewhere typically lay off in markets. Too much project risk stays with banks because other financial instruments such as equity and subordinate debt cannot be issued cheaply.



Risk also returns through the back door.

For example, banks do not make loans to housing developers because of their intrinsic risks.

But they do make loans to non-bank financial companies, which make loans to developers. To prevent risk from returning to bank balance sheets, NBFCs must be able to raise money directly from markets.

Financial market development, addressed in Eswar Prasad's note in this volume, will help banks focus more on risks they can manage better and thus bear more effectively, while sharing or laying off what they cannot.

Banks will have to complement financial markets rather than see them as competition. The use of financial technology will be especially helpful to them in this endeavour.

Reduce the number and weight of government mandates for PSBs

Uncompensated government mandates have been imposed on public sector banks for a long time. This is lazy government - if an action is worth doing, it should be paid for out of budgetary resources.

Mandates also are against the interests of minority shareholders in public sector banks.

Finally, it does not draw the private sector in to compete for such activities. The government should incentivise all banks to take up activities it thinks desirable, not impose it on a few - especially as the privileges associated with a banking licence diminish.

Along these lines, requirements that banks mandatorily invest in government bonds (the SLR requirement) should continue to be reduced, substituting them instead with the liquidity coverage ratios and net stable funding ratios set by Basel. Among the more dangerous mandates are lending targets and compulsory loan waivers.

Government-imposed credit targets are often achieved by abandoning appropriate due diligence, creating the environment for future NPAs.

Loan waivers, as the RBI has repeatedly argued, vitiate the credit culture and stress the budgets of the waiving state or Central government. They are poorly targeted, and eventually reduce the flow of credit.

Agriculture needs serious attention, but not through loan waivers. An all-party agreement to this effect would be in the nation's interest.

Finally, the government should keep its banks well capitalised, conditional on improvements in governance and management efficiency. This is simply good accounting practice, for it prevents the government from building up contingent liabilities on bank balance sheets that a future government will have to pay for.

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The solutions

■ The P.J. Nayak Committee recommended a path to greater independence for public sector banks, and its ideas should be implemented. Eventually, public sector bank boards should be independent and accountable, and allowed to choose the banks' CEOs

■ Banks need to build up more in-house talent for such specialised tasks as managing project finance. Public sector banks may have to start paying more to attract world-class talent

■ Some mid-sized public sector banks should be privatised as a test case

■ Banks should not be forced to implement the government's policy priorities. In particular, an all-party agreement that loan waivers should be avoided is in the national interest