

November, 2022

CRIME AND PUNISHMENT



M. Damodaran
Chairperson, Excellence Enablers
Former Chairman, SEBI, UTI and IDBI

Every serious crime or misdemeanour must be visited with penal consequences. In doing so, should the principle of proportionality be factored in?

There are rare occasions when Regulators have to scramble to put together arrangements to address the fallout of business having to be discontinued by a regulated entity. It is not always that Regulators have the luxury of time, to get into the normal consultative process, to determine what would work best on such rare occasions.

On October 13, 2022, SEBI addressed a communication to all concerned, indicating the steps to be taken in the event of suspension, cancellation or surrender of certificate of registration of a Credit Rating Agency (CRA). This communication was necessitated by an order passed by a Whole-time Member (WTM) of SEBI, directing the cancellation of the license of a CRA registered with SEBI. It is not the purpose of this newsletter to go into the merits of the case, and take a view on whether the irregularities that were alleged, have been established. That matter is to be decided by the Appellate Authority. Even as this newsletter gets into print, the Appellate Authority has stayed the order passed by the WTM.

SEBI's communication under reference indicates clearly that its purpose is to facilitate orderly migration of credit ratings arising out of cancellation or suspension ordered by SEBI. The various steps to be taken by the entity concerned have been laid down in sufficient detail, and there appears to be no material omission. Similarly, the impact of the discontinuing of ratings provided by the agency, which has had its license cancelled or suspended, has been addressed. There are also directions to listed entities or issuers who have obtained credit ratings from a CRA whose registration is cancelled, suspended or surrendered.

One of the questions which refuses to go away in every case relating to punitive action taken against any entity is whether the punishment is inadequate, adequate or excessive. The credit rating business is a systemically important business. It does not matter whether, or not, the entity concerned is one of the smaller players providing that service. Therefore, while ensuring that the punishment is adequate to disincentivise any other entity from travelling down the same path, it is necessary to examine whether any penalty, other than what is proposed to be imposed, meets the requirements of public interest.

This is not the first occasion on which a CRA has been seen as not measuring up to expectations. During the financial meltdown of 2008, global CRAs were found to have, through action or inaction, contributed to the build-up, and the consequent fallout, of the serious problems in the financial ecosystem. At that time, no CRAs had their licenses cancelled or suspended.

Failures, including many for the wrong reasons, are common in the banking industry. Even in India, there have been very major banking failures, contributed to in significant measure, by promoters or persons incharge of management. On such occasions, the banking Regulator sometimes appoints to the Board of that regulated entity, one or more Directors, to ensure that business is conducted in an orderly manner, and that the shortcuts resorted to in the past, remain a matter of the past. The question that therefore needs to be addressed is whether in the event of failure of a rating agency, the Regulator could have appointed two persons to the Board, and if necessary, to the management positions, and effectively neutralised the promoters, who were in management positions. Yet another possibility, in grave circumstances, is the suspension of the license of that entity. This would have serious consequences for the clientele, since in addition to the entity not being able to take on new business, its ability to service the existing business would also be disrupted. The advantage of suspension, when compared with cancellation, is that the entity survives, and can be rebuilt on healthy lines with a new management in place. Yet another possibility is the merger of the defaulting entity with a larger healthier entity in the same line of business. This would ensure that the customers are not left high and dry for no fault of theirs. Migration, no matter how carefully it is planned and implemented, will have within it, at least temporarily, some elements of disruption, which will adversely impact the customers.

Credit rating is a serious business. If the faith of the financial ecosystem is undermined by alleged irregular practices by a rating agency, and the consequent termination of its license, it will not bode well for the future. There would also be questions asked, at least in private conversations, whether the other rating agencies can be counted on to provide completely reliable services. It may be recalled that when Satyam Computers went under, there were questions in the minds of some persons as to whether other IT companies also had issues of this nature. The reputational impact is therefore not only on the entity which has had its license cancelled, but also on other entities, especially those which, not so long ago, had fairly serious brushes with regulatory agencies, and saw the exits of their Chief Executive Officers. There is an expectation among some persons that this action taken against one of the rating agencies could lead to the practice of shopping for ratings by issuers being discontinued. This can, at best, be a fond hope, rather than a legitimate expectation.

As already indicated, the matter is before the Appellate Authority. There will be findings on whether SEBI's order seeking to establish multiple irregularities, survives appellate scrutiny. It is expected that notwithstanding the merits of the allegations which have been established by SEBI's order, the appropriateness of the penalty in such cases would also be addressed, not necessarily from the point of view of the promoter, but keeping in mind the public interest, including the need to minimise disruption, and ensure that the blameless customers do not end up paying a price however small or temporary.



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INAUGURAL SESSION

Thursday, 17th November, 2022

Growth with Governance – Can Ethics and Economics coexist?

Mr. Deepak S. Parekh

Chairman, HDFC

Mr. S. N. Subrahmanyam

MD & CEO, Larsen and Toubro

Mr. Dinesh Kumar Khara

Chairman, State Bank of India

Summit Introduction - Mr. M. Damodaran

PLENARY SESSION

Friday, 18th November, 2022

Corporate Governance – Talking the Walk

Mr. Harsh Mariwala

Founder & Chairman, Marico

in conversation with Mr. M. Damodaran

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