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JPC REPORT X- RAYED

The stock market scam and the UTI imbroglio
From Stodgy Socialism to Crony Capitalism

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JPC REPORT X-RAYED

The stock market scam and the UTI imbroglio

From Stodgy Socialism To Crony Capitalism

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I- The Stock Market Scam

Scam: Definition. Scope. Duration and Component Elements

Stock markets around India crashed during March-April 2001. They are yet to recover from the sensex level of around 3000 where the index has been stagnating for the past two years ever since the crash.

At the height of the 1999-2000 boom, sensex had crossed the high watermark of 6000. By 12 April 2001, the sensex had tumbled to 800 points below its early March level and a huge number of skeletons had started tumbling out of the cupboard:

- the involvement of a bewildering number of banks, brokers and corporates in exploiting every available loophole left gaping open by Government and its regulators;
- rampant irregularities in all major stock exchanges;
- persistent irregularities in several banks;
- nexus between banks, brokers and corporates to subvert the integrity
- of the market;
- Ketan Parkeh's malfeasance;
- swindles in urban cooperative banks like Madhavpura Mercantile Cooperative Bank in the deputy Prime Minister's constituency and City Cooperative Bank in the Prime Minister's constituency;
- the payments crisis on the Calcutta Stock Exchange; and
- misuse of the Mauritius route for investment in our stock markets

The hardest hit, of course, was the innocent individual investor who had put his trust in the Government and its regulators and other agencies to ensure the integrity of the market.

Thus, although the Government had resisted the Opposition demand for a Joint

Parliamentary Committee (JPC) to probe the scam when it surfaced in March 2001, it was left with no alternative but to concede the demand when Parliament resumed its budget session in the second half of April, 2001. The JPC's unanimous Report was submitted to Parliament on 19 December 2002. It is expected to be discussed when Parliament reconvenes in February 2003.

It was evident that both the artificial boom and the inevitable bust involved a variety of malpractices. These went unchecked because the Ministry of Finance and its regulators, in particular the Securities Exchange Board of India (SEBI) and the Reserve Bank of India (RBI), grievously failed in the performance of their duties**.** The Government and its regulators were more concerned with stoking the "feel good factor" than with ensuring the integrity of the market when the market was dizzily spiralling upwards. They only got concerned when the market collapsed. As the JPC report remarks:

> "When stock markets were rising, there was general lack of concern to see that such a rise should be in consonance with the integrity of the market and not the consequence of manipulation or other malpractice. On the other hand, when the markets went into a steep fall, there was concern all over" (para 2.12, page 8).

The small investor enters the market in the expectation that the Government and its regulators will ensure the integrity of the market, so that whether the market rises or falls, market behaviour is not the consequence of rigging or other malpractices and irregularities. Of course, no one can stop fraudsters from attempting to deceive ordinary investors. But if there is persistent malpractice, and is known - or should be known - to the Government and its regulators, and yet little or nothing is done quickly to restore integrity to the market, then ***repeated fraud accompanied by persistent failure on the part of the authorities to close the loopholes, becomes a scam.*** The **JPC** defines the expression "scam" in the following terms:

> "Individual cases of financial fraud in themselves may not constitute a scam. But persistent and pervasive misappropriation of public funds falling under the purview of statutory regulators and involving issues of good governance becomes a scam." (para 2.7, p.7)

The issues dealt with in the JPC report pertain to the "persistent and pervasive" failure of the key regulators to perform their duties and the failures of "good governance" pertain primarily to the failure of the Ministry of Finance to perform their duties. They also include the failings of the Department of Company Affairs (which is both a department of government and a regulator) as well as the investigative agencies (CBI, Enforcement Directorate etc) which fall directly under the Prime Minister.

The duration of the scam has been defined by the JPC in the following terms:

> "The events that culminated in the exposure of the scam in March 2001 started approximately eighteen months earlier" (para 3.1, p. 12)

As the NDA government took office in March 1998, three years before the "exposure of the scam", the entire 18 months duration of the scam reflects on the statutory regulators at the time and the ministers responsible at the time for the deficiencies in "good governance" which led to and pervasively persisted through the duration of the scam.

The failures of regulation have been summed by the JPC as follows:

> "Regulatory authorities should have been able to lay down and implement guidelines and procedures that could prevent such a scam or at least activate red alerts that could lead to early detection, investigation and action against fraud as well as the rectification of any systemic deficiencies discovered" (para 2.8, p7).

The failures of governance have been summed up by the JPC as follows:

> "Equally, supervisory authorities and coordinating bodies such as the Ministry of Finance and HLCC (High Level Committee on Financial and Capital Markets), should have been more pro-active and vigilant in recognizing that liberalization requires strong and effective regulation, and greater autonomy for regulators must go hand-in-hand with the accountability of regulators to the country through Ministry of Finance which, in our scheme of constitutional jurisprudence, is responsible to Parliament for the financial health of the economy, including sectors regulated by statutory and other regulators" (para 2.8, p.7).

As regards the joint failings of regulation and governance, the JPC has this to say:

> "Concerted mutual interaction between Government and the Regulators, especially through the institutional mechanism of HLCC, could have signally contributed to effective pre-emptive and corrective action to forestall or moderate the scam by early detection of wrong-doing" (para 2.8, p.7).

The JPC's final judgment then runs as follows:

> "Clearly, the various regulatory authorities were not able to foresee the situation leading to the scam and prevent it. Nor was adequate attention paid in government circles, particularly the Ministry of Finance as the custodian of the financial health of the economy" (see insertion at SI. No. 2A, p.437, dropped by a printing error from the main body of the Report)
>
> and
>
> "There can be no escaping Government's responsibility to Parliament and he country" (para 2.16, p.9).

So, is or is not the Minister of Finance (and the Minister of Company Affairs, indeed, the government as a whole under the principle of collective responsibility) to be held responsible to the country by Parliament in the light of these unanimous findings of the JPC, cutting across all party lines?

Ministerial Responsibility for The Scam

The JPC's answer to this question is unambiguous. It cites, at para 13.2 page 309, the previous JPC's examination of the distinction sought to be made then by the Minister of Finance between his "direct responsibility" for "broad policy decisions" and "administrative failures or management deficiencies" for which, he had said, the Finance Minister "cannot be held responsible." The 1992 JPC had held that

> "such a distinction cannot be sustained by the constitutional jurisprudence under which the parliamentary system works".

That JPC also held that

> "the principle of constructive ministerial responsibility is equally applicable to other Departments and Ministries".

This JPC says:

> “The Committee are agreed that ministerial responsibility in regard to this Report flows from these principles." (para 13.3, p.310)

In taking into account in its report "the parameters of governmental responsibility" (para 2.20, p. 10), the JPC have faulted the Ministry of Finance in at least 52 paragraphs of the report! As there can be no Ministry without a Minister, ministerial responsibility for the failings of the ministry has to be fixed in terms of the doctrine of ministerial responsibility evolved by the previous JPC and reiterated by the present JPC.

Indeed, Dr. Manmohan Singh in his reply to the previous JPC quoted at para 13.2, p.309 of this JPC Report accepted "direct responsibility" for "the work of the Ministry." Where the Ministry is directly faulted, the responsibility must ultimately rest with the Minister. And even where a regulator is at fault, the minister cannot escape his responsibility to Parliament for failing to identify and rectify these lapses:

> “Regulators are accountable to the Ministry of Finance which, in turn, is responsible to Parliament" (para 13.45, p.319)

That is how the Parliamentary system works. And that is how Shri Yashwant Sinha and his six colleagues in the present Council of Ministers who were members of the 1992-93 JPC (S/Shri Jaswant Singh, George Fernandes, Ram Naik, Murasoli Maran, Harin Pathak and Digivijay Singh) viewed “the constitutional jurisprudence under which the parliamentary system works". And it was the present Prime Minister who as Leader of the Opposition when the Lok Sabha debated the earlier JPC report on 29 December 1993 had insisted on Government owning “the moral responsibility" for everything “rotten" in the system uncovered by that JPC report. What is sauce for the goose must surely be sauce for the gander.

The JPC have found that:

> “The scam does not lie in the rise and fall of prices in the stock market but in large scale manipulations like the diversion of funds, fraudulent use of bank funds, use of public funds by institutions like the Unit Trust of India (UTI), violation of the risk norms on the stock exchanges and banks, and use of funds coming through overseas corporate bodies to transfer stock holdings and stock market profits out of the country" (para 2.20, page 10).

The JPC then goes on to say:

> “These activities went largely unnoticed" (para 2.20, p. 10).

With a freshly minted Capital Markets Division in place, put in place, moreover, as a response to the report of the previous 1992-93 JPC, this JPC finds, a decade later, that the Ministry of Finance and its regulators “largely" failed to notice that the capital markets were going awry. And this at a time when stock market turnover exponentially increased from a daily average of some Rs.300 crore to Rs. 12,000 croer day, sometimes breaching even Rs. 15,000 crore!

Also faulted is the Department of Company Affairs (DCA), which is the regulator for corporate entities. It was so poorly staffed that it had “only about 18 inspectors in the whole country" to regulate several lakh corporate entities (para 7.5, p. 147). And the minister did nothing about either hiving off the responsibility to an independent regulator or strengthening his department to enable it to effectively perform its regulatory duties. In consequence, as the JPC observes:

> “That the promoters and corporate entities were, at the relevant time, playing a significant role (in the scam) cannot be denied. The Department of Company Affairs could have, had it informed itself of this or been alerted to the role of promoters and corporate entities, taken timely action in the matter" (para 7.4, p. 146)

It did not, and so the scam occurred.

DCA also inexplicably delayed the processing decade-old legislative proposals from the Institute of Chartered Accountants for strengthening their powers of disciplining delinquent auditors (para 11.39, p.262, also para 3.18, p.15 where "the government" is *inter alia* faulted for “complete lack of urgency and disregard of promises"). Also faulted is the “admittedly" poor quality of DCA inspections (para 11.40, p.262). Indeed, given DCA's paucity of staff and casual approach to regulating corporate entities after the closing down of the office of the Controller of Capital Issues in the name of liberalization (para 11.22, p.258), the market fro capital issues had in effect become a free-for-all. The JPC have observed:

> “a liberalized regime should have been accompanied with effective regulatory provisions, but these are clearly missing in the Companies Act. The penalties are nominal, the offences are easily compounded, and even investigations or special audits (which are merely fact-finding steps) can be undertaken only after lengthy procedures, which render these measures ineffective for any speedy action" (para 11.15, p.255).

DCA was so ineffective and inactive during the period of the boom, and the build up to the boom, which preceded the bust that at least 229 companies which collected crores upon crores of savings from small investors in the liberalised atmosphere of the market have simply vanished into thin air "and are not available now at their registered offices" (para 11.28, p.259).

The JPC have also found that DCA took no action on the massive diversion of funds from corporates to brokers to play the stock market. Indeed, according to DCA itself:

> "the removal of restriction on Section 372-A, that is, inter-corporate deposits two years back (i.e. 1999) by way of liberalised amendments has been the major reason for huge transfers of money from companies to Ketan Parekh." (para 11.7, p.254)

These transfers amounted to over Rs: 2000 crore in the case of the Ketan Parekh group of companies alone. Other brokers are still to be investigated.

The dodges resorted to included the following ruses undiscovered or ignored by DCA:

> "the largest, often listed, company in a group has transferred its money to other group companies, normally private or at least unlisted, and these smaller group companies have then transferred the funds to the Ketan Parekh group of companies; further, once the money reached any company of the Ketan Parekh group, it was often rotated amongst the various companies of the group" (para 11.8, p.254).

While, post the unearthing of the scam, there has been a flurry of proposals for legislative amendments and committees to see how things can be put right (including the Shardul Shroff and Naresh Chandra committees), during the period when the artificial boom was being stoked by such irregular, improper and illegitimate practices, DCA took no steps to render them illegal by the simple device of bringing to Parliament legislative proposals now put so belatedly on the anvil. The department was then under the charge of Shri Arun Jaitley. Instead of firmly keeping him out of the government for his gross negligence, he has just been restored to the Council of Ministers!

Besides, the Government's investigative agencies, such as CBI and the Enforcement Directorate, which fall directly under the purview of the Prime Minister, have also been indicted by the JPC. "It is really shocking," says the JPC (para 12.74, p.278) that of the 72 cases registered by CBI in connection with the 1992 securities and banking scam, "only 6 cases could be disposed of:

> "Lack of urgency on the part of the Government has led to a stage where after more than 9 years, 66 out of 72 cases of the 1992 scam have yet to be adjudicated. This clearly sends out a signal that future wrong doers can evade the consequences of their wrongs and can also enjoy their ill-gotten gains" (para 3.11, p.14). In fact, as can be seen from the figures supplied by CBI (para 3.8, p. 13), in as many as 25 of the 72 cases registered even charge-sheets are still to be filed!

Moreover, as stated at para 3.11, p.14, of the 5 special courts that were to have been set up “only two courts were really functional". It is for Government, specifically the Prime Minister under whom CBI functions, to explain why after a whole decade it takes a Joint Parliamentary Committee to plead for “a sense of urgency". In such a permissive atmosphere, where Government is not ensuring that "laws are ultimately implemented effectively and the guilty punished in an expeditious manner", a second scam was inevitable - and it happened.

The JPC have also faulted the UP Government, then under the BJP, for not checking the various excesses of the City Cooperative Bank:

> “Though under the UP Cooperative Societies Act, 1965 wide powers of conducting inspection, enquiry and audit are vested with the Registrar of Cooperative Societies, these powers were not exercised to check the functioning of the bank" (para 5.111, p.78)

All three Johari group entities - City Cooperative Bank, Cyberspace Infosys and Century Consultants - located in the Prime Minister's constituency of Lucknow have been found by the JPC to have been deeply involved in a whole series of irregularities and worse. The full story of the wrongdoings of the three entities is recounted at paras 12.31-12.40, pages 270-272. Yet, everyone concerned - specifically RBI and the UP government - winked at these known delinquencies (para 5.109, p.77). Indeed, the Johari group enjoyed such close relations with the UP government and the local BJP establishment that the Prime Minister himself inaugurated Cyberspace Infosys. With such clout, Cyberspace Infosys then went on to collude with UTI to "enter into a criminal conspiracy ... to cause wrongful loss of approximately Rs.32 crores to UTI" (para 12.32, p.270). This is the nature of the company the Prime Minister kept.

Boom and Bust

The JPC says:

> "While the stock market was rising, there was inadequate attempt to ensure that this was not due to manipulations and malpractices. In contrast, during the precipitous fall in March 2001, the regulators showed greater concern." (para 2.20, p. 10)

It is this that has led the JPC (para 2.12, p.8) to zero in on the "dissonance in approach to issues of regulation and good governance" between when the market was rising in 1999-2000 and when it collapsed in March-April 2001

It is to be particularly noted that the JPC has identified both "issues of regulation", which are the concern of independent statutory regulators like SEBI and RBI, and issues of "good governance" which are - or should be - the concern of the Ministry of Finance and other government departments concerned, indeed, of government as a whole.

The Opposition in Parliament had frequently drawn the attention of Government to their apprehension of malpractices in the stock market when the market was booming, in particular to the glaring contrast between inactivity in the primary stock market where fresh investment is mobilised and frenetic activity in the secondary market where existing stock holdings are traded. The Opposition had also contrasted the stagnation in the real economy - low growth rates in agriculture, industry, infrastructure, exports, foreign direct investment etc - with the runaway boom in the stock market. The Government paid scant attention to these Cassandra warnings.

Therefore, as soon as it became public knowledge that SEBI had instituted on 2.3.2001 its enquiry into the fall of the market, where no similar enquiry had been made in regard to the rise of the market, the Opposition in Parliament began agitating for a Joint Parliamentary Committee (JPC) to enquire into the scam. The Government initially refused to concede the demand for a JPC, arguing, as Finance Minister Yashwant Sinha did in the Rajya Sabha on 13 March 2001, that there was "no big scam" and the regulators were doing a good job of ensuring the safety and integrity of the stock markets.

Far from there being "no big scam", the JPC have found that:

> "Under the present system, there is no deterrence to malpractices, irregularities

and manipulations in capital markets" (para 3.10, p. 13)

and

"There being no fear that swift and effective action will be forthcoming, the players in the financial world ignore the laid down rules, regulations and procedures without any fear of punishment" (para 3.4, p. 12)

Pointing out that

"Unless the regulators are alert and the punishment is swift and adequately deterrent, scamsters will continue to indulge in financial misconduct" (para 3.10, p. 13), the JPC have uncovered "a practice of non-accountability in our financial system":

"The effectiveness of the regulations and their implementation, the role of the regulatory bodies and the continuing decline in the banking system have been critically examined, for which the regulators, financial institutions, banks, Registrars of Cooperative Societies, perhaps corporate entities and their promoters and managements, brokers, auditors and stock exchanges are responsible in varying degrees" (para 2.20, p. 10).

Urban Cooperative Banks and The Scam

While it was public sector banks which were the prime cause of the securities and banking scam that broke in 1992, this time the worst offenders were urban cooperative banks (cf. para 2.11, p.8), particularly City Cooperative Bank, associated with the Johari brothers and located in the Prime Minister's constituency of Lucknow, and Madhavpura Mercantile Cooperative Bank (MMCB), associated with Ketan Parekh, and located in the deputy Prime Minister's constituency in Gujarat.

The deficiencies in RBI's regulation of City Cooperative Bank, Lucknow and the related ventures of the Johari brothers - Cyberspace Infosys and Century Consultants - have been adumbrated at pages 69-77 of the JPC report. Thousands of depositors have been robbed of crores of their savings because of the poor showing of the regulator. The delinquencies of City Cooperative were fostered by RBI and the UP Registrar of Cooperatives not following up their own findings. These delinquencies have since been found to include:

- investment of Rs.6.50 crore in Cyberspace Infosys, a related Johari concern, "against RBI instructions which prohibit investment in the equity of such companies" (para 5.70, p.70);
- "misutilization" by Shri A.K. Johari of nearly Rs.21.50 crore of the bank's outstanding investments (para 5.71, p.70);
- "the Bank had not framed any loan policy. There was no system of credit appraisal. No loan committee was formed and the credit decisions were mostly taken by Shri A.K. Johari" (para 5.72, p.70);
- Rs. 2.62 crore of the bank's term deposits, encashed but not accounted for (para 5.73, p.70);
- advances "much in excess" of RBI ceilings (para 5.74, pages 70-71);
- violation of "RBI directives on unsecured advances" (para 5.75, p.71) and of

"the guidelines of RBI on credit exposure" (para 5.77, P-71);

- purchase by the bank of cheques from front companies "belonging to Shri A.K. Johari" (para 5.76, p.71); and
- "extremely unsatisfactory" liquidity position of the bank (para 5.78, p.71).

City Cooperative Bank got away with all this and more because they were lionized as a new breed of entrepreneur instead of being kept to the strait and the narrow by the regulators.

Cooperatives are the joint responsibility of the regulator, the state government and the central government. The responsibility to Parliament for the health of cooperative banking is primarily that of the Finance Minister. The rescue packages that have been put together are at the cost of the nation's wealth. However justified the bailing out of innocent depositors might be, can the minister and the state/central governments concerned be exculpated of all responsibility for the loot of the urban cooperative banking sector?

The nexus between RBI's regulatory inadequacies and the state Registrar of Cooperatives, disturbingly stark in the case of the City Cooperative Bank, is just as stark in the case of the Madhavpura Mercantile Cooperative Bank (MMCB) in Gujarat, a state run then and since by the BJP**.**

The JPC deals at length with MMCB (pages 54-69) and finds that although the ills of the bank were well known to RBI, nothing substantive was done to rectify these ills (paras. 5.54-5.58, pages 66-67). As far back as the RBI inspection of 1999, it had been found that "the standard of credit appraisal obtaining in the Bank was deficient" (para.5.58, p.67), RBI did nothing to bring MMCB back on the rails of banking propriety. Indeed, as stated at para 3.21. p. 16, even though RBI has a "full-fledged regional office in Ahmedabad headed by a regional director to oversee urban cooperative banks in the Slate of Gujarat", and although "it was incumbent on this office to in vesligate the abnormally high fund transfers in the last one year prior to the scam", the RBI regional office did not do so. Nor did the Gujarat government.

The RBI had recommended that an Audit Committee be constituted by MMCB, but notwithstanding discussions between RBI and the CEO of MMCB on 23.6.2000, the Audit Committee was "not constituted and irregularities in the bank's operations went undetected leading to its collapse in March 2001" (para 3.20, p. 15).

As early as 1998, one Shri Jasubhai S. Patel had registered a complaint against MMCB with the state Registrar of Cooperatives, but no effective action was taken by the Government of Gujarat on the complaint. And although "after conducting its own investigation, RBI found that Chairman of the Bank was indulging in all sorts of malpractices for personal gain" as well as "other regularities", the Gujarat Registrar of Cooperatives "merely reiterated the clean chit given earlier by the District Registrar" and RBI did not take up the matter with the Central Registrar of Cooperatives "as it should have" (para. 5.60, pages 67-68). The road was thus opened for "the Bank improperly and illegitimately making vast sums available, under various guises, to certain stock brokers, in particular entities controlled by Shri Ketan Parekh" (para 5.54, p.66).

These were the main ingredients of the scam. Yet, owing to the inadequate and even misleading briefing give by the chairman of the JPC on 19.12.2002, media headlines on the presentation of the JPC report described Ketan Parekh as the "root cause" of the scam. The JPC report (para 2.15, p.9) describes Ketan Parekh as a "key player", not as

the "root cause". Of course, Ketan Parekh and others manipulated the market but they got away with this for as long as they did because the regulators and the Government left the loopholes gaping wide:

> "Not till the MMCB crash occurred did the regulatory authorities even begin looking in Shri Ketan Parekh's direction although this was being underlined in Parliament and the media. It is difficult to believe that the Stock Exchanges or SEBI were quite unaware of what was going on in the market when Ketan Parekh entities were manipulating the market using their network. Nor did the High Level Coordination Committee (HLCC) or the SEBI seek a check on where Shri Ketan Parekh was getting his funds from or his methods of manipulating the market. This is all the more disturbing in (lie context of the previous JPC's findings against Shri Ketan Parekh" (para 4.42, pages 28-29).

Since, as the JPC notes, the role of Ketan Parekh was being underlined "in Parliament", it was the Finance Minister's responsibility to act on matters being agitated in Parliament. This was not done. Instead, the "feel good factor" was the priority and the nexus between banks, brokers and corporate entities was winked at.

Non-implementation of 1992 JPC Recommendations and the Scam

The JPC deplores the fact of the Special Cell set up by Dr. Manmohan Singh to go into the broker-bankers-corporates nexus "having gone defunct" (para. 2.21, p. 11). The collapse of the Special Cell is the subject of adverse JPC comments at several different paragraphs: 2.19, 3.12-3.14, and 7.3, the fault lying entirely with the Ministry of Finance and its minister, the minister because the Special Cell was a commitment made to Parliament through the ATRs of 1994**.**

It was "the lack of progress in implementing the recommendations of the last JPC**...** (which) emboldened wrong-doers and unscrupulous elements to indulge in financial misconduct" (para 2.21, p. 11). Therefore, the JPC "are concerned to note that":

> "the Ministry of Finance took so casual an approach to the implementation of JPC 1992 recommendations, as set out in the two ATRs of 1994, that they neither monitored implementation nor informed successive Finance Ministers of non-implementation" (para 3.32, p. 18).

Of course, the "successive Finance Ministers", specifically Shri Yashwnat Sinha who was in that august office for the period of eh scam, never cared to inform themselves of "non-implementation".

As this explains in large measure the onset of a second scam in a decade, the JPC have been obliged to

> "express their concern at the way the supervisory authorities have been performing their role and the regulators have been exercising their regulatory responsibilities" (para 2.21, p.ll).

"No financial system," observes the JPC,

> "can work efficiently even if innumerable regulations are put in place unless there is a system of accountability, cohesion and close cooperation in the working of the different agencies of the government and the regulators" (para

2.21, p.l 1).

Precisely with a view to ensuring such "cohesion and close cooperation", Dr. Manmohan Singh had in 1992 constituted a High Level Committee on Capital Markets (HLCC) under the chairmanship of Governor, RBI, comprising the heads of the regulatory agencies and the senior-most officers of the Ministry of Finance, serviced by the Capital Markets division of the ministry. The JPC have found that the HLCC "has not carried out its mandate to regularly review the position regarding financial/capital market" (para 13.50, p.321). The JPC have also found that: "The Ministry of Finance, on its part and in relation to the assurance given by it to Parliament in the revised Action Taken Report, has not referred such crucial issues to the HLCC." It then concludes:

> "Had these issues been taken up by the HLCC periodically, it would have definitely helped in minimizing, if not averting altogether, the irregularities which have surfaced in the present scam" (para 13.50, p.321).

With regard to the unconscionable delay in processing the ATR commitments made by the Ministry of Finance to Parliament in regard to the 1992-93 JPC report, for delays in processing legislative proposals from the Institute of Chartered Accounts for effective disciplining of delinquent chartered accountants, the Department of Company Affairs, then run by Shri Arun Jaitley, is primarily responsible. Shri Yashwant Sinha, for his part, as minister of finance, must bear the responsibility for tardiness in processing a whole raft of legislative proposals sent to his ministry over the years for strengthening the regulatory regime (detailed at pages 242-243).

Sinha himself told the JPC (para.2.9, p.8) that he had not "imagined" that recommendations of the previous JPC "were still to be implemented". Typically, he blames this on not having been "told that any or many of the recommendations of the JPC were still be implemented." Should a minister wait to be told - or should he go out and find out? In fact, the most hilarious part of an otherwise dull and serious Report is Appendix III of Volume II which sets out as many as 32 recommendations of this JPC which are analogous to the recommendations of the previous JPC, "starkly revealing the extent of non-implementation which characterises the system" (para 3.33, p. 18).

It is such negligence on the part of Government and its regulators that lies at the root of the scam. Here we have in a nutshell the genesis of crony capitalism in the name of liberalisation.

It is, therefore, necessary to examine the role of the ministry in regard to the regulators to establish the nature of ministerial responsibility for the scam.

Regulators and the Ministry of Finance: SEBI

What control is to the command economy, regulation is to the market economy. Effective regulation is the key to market integrity. The regulator is not there to see whether the market is going up or down but to ensure that whether the market rises or falls, this reflects market sentiment, not market manipulation or other irregularities. The regulator must also assume that at all times there are fraudsters looking for opportunities to exploit any weaknesses in regulation. The regulator must, therefore, ensure that existing regulations are being strictly observed; more important still, the regulator must be alert to any signals of regulations being subverted or by-passed so that corrective action is taken as quickly as possible. A regulator who waits for the horse to flee before bolting the stable door is not doing its duty.

Tragically, the key statutory regulator for the stock exchanges, SEBI**,** fell flat on its face through both the boom and the bust:

> "Regular inspection and follow up action of Stock Exchanges was obviously not implemented properly by SEBI" (para 3.29, p. 17).

The JPC's recitation of the failings of SEBI stretch over nearly 25 pages of the report (187-209) and SEBI is also faulted at several other places in the report relating to virtually every aspect of the scam. The JPC have found that SEBI inspections were of very poor quality; that there was little follow up to the deficiencies uncovered by SEBFs own inspection reports; that SEBI's nominee directors had a very poor record of attending meetings of the boards of stock exchanges; and that SEBI did nothing to correct "apathy" on the part of the stock exchanges, which are the primary regulators of the stock market (paras 9.27-9.30, p. 193 and para 9.52, p. 198. See also 2.10, p.8; 7.3, p.146; and 7.51, pl 64).

The JPC, at para 9.64, p.200, lists five key areas of concern where "SEBI appears to have done nothing particularly substantive":

- monitoring and regulating the massive inflow of some Rs.50,000 crore from abroad into the stock market;
- mismatch between the primary and secondary stock market;
- mismatch between the huge number of listed scrips and the small number of actively traded scrips;
- rise in private placements to the detriment of the primary market; and
- "negligence" in checking on whether bull operators were overtly or covertly obtaining improper bank funding.

Little wonder then that fraudsters had a field day deceiving investors while the government prided itself on the "feel good factor" which pervaded the stock market.

"It was SEBIs job," says the JPC, "to ferret out the irregularities and defuse them before they blew up. This was the primary job of SEBI which they failed to do on time." (para 9.66, p.201).Tragically, "It was SEBIs job," says the JPC, "to ferret out the irregularities and defuse them before they blew up. This was the primary job of SEBI which they failed to do on time." (para 9.66, p.201). SEBI did not act on alerts generated by the three main stock exchanges: Bombay Stock Exchange (BSE); National Stock Exchange (NSE); and Calcutta Stock Exchange (CSE).

Thus, SEBI failed "to analyse why the BSE index reached a phenomenal high in February 2000":

> "Absence of an investigation when the BSE index unusually rose contrary to the fundamentals of the stock markets represents the failure of the regulator. Had steps been taken by the regulator at the relevant time, perhaps the phenomenal rise could have- been contained and the defaults avoided. The regulator should have known that regulation of the market could only be provided through constant vigil and in cooperation with other regulatory authorities."

SEBI failed to do this even though "there was sufficient contemporaneous evidence to put the Regulator on vigil" (para 9.69, p.201). The fault, points out the JPC, does not lie with SEBI alone: "much that went wrong might have been forestalled" had "the Ministry of Finance been more insistent on SEBI measuring up." (para 9.68, p.201).

On NSE, SEBI failed to act even after NSE on 18.8.2000 brought to the attention of the Regulator their concerns about "group companies and fund flows that supported the volumes of certain ICE (Information, Communications and Entertainment) scrips." NSE turnover averaged a phenomenal growth of 86% per annum in the five years between 1995-96, when the exchange was established, till the scam broke in March 2001. Indeed, in a single year, 2000-01, NSE turnover increased by Rs.6 lakh crore largely owing to the Automated Lending and Borrowing Mechanism (ALBM), a device for deferral operations, the single biggest user of which was Reliance Securities, its single largest client being another Reliance group company, Reliance Petroleum (para 6.137, p.141). Noting that "SEBI's handling of the issue relating to the revised ALBM leaves much to be desired", the JPC have remarked that the "funds deployed by one player" amounted to "as much as Rs.1900 crores towards the end of February 2001." This large amount was not redeployed, "leading to adverse impact in the market". Yet, SEBI did not see fit to include Reliance Securities in its initial list of entities to be investigated for the post-Budget fall in the market.

While the Ministry of Finance is faulted for not being pro-active in regard to the curious goings-on in BSE and NSE, then finance minister Yashwant Sinha's own role in answering the Calling Attention Motion in the Rajya Sabha on 13.3.2001 on the payments crisis on the Calcutta Stock Exchange is the key element to focus on in the JPC's recounting of the CSE tale.

The JPC note (paras 6.15 and 6.16, p.117) that the then Finance Minister told the Rajya Sabha that:

- “there has been no payment problem";
- “there was a delay of just one day because of the fact that some hunks were closed etc.";
- “there is no danger of a payment crisis";
- “the trade guarantee funds which are available with the stock exchanges are sufficient to be able to take care of any problem".

In fact, as the JPC's careful recitation of the facts at pages 115-117 of the Report establishes:

- there *was* a payment problem;
- the delay was *not* on account of banks being closed;
- a payment crisis *did* arise in subsequent settlements because of improprieties in effecting the initial settlement; and
- CSE *had to eventually dip into its reserves* because it did not have enough guarantee funds.

The initial settlement, involving a default of Rs.32 crore the week before FM spoke in Parliament, was effected largely by UTI buying Rs.25 crore worth of dud DSQ Software shares to relieve a defaulting broker (para 6.85, p. 130 and Chapter XVIII, pages 389-402). The JPC conclude that the "unit holders of UTI have been subjected to a

loss of Rs.21.40 crore as on 28.6.2002" (para. 18.18, p.400). It was none of UTI's business to come to the rescue of the CSE. There was no justification for the UTI chairman agreeing to his executive director's recommendation of loading the UTI investor with the problems of a defaulting broker. Indeed, even the contact between CSE and UTI in this regard was highly improper. Not only was this done, the news of UTI bailing out CSE was published in *Business Standard* on 11 March 2001 without provoking any rebuke to UTI from the finance ministry or its minister. The Minister made no mention of this when he assured the Rajya Sabha next day that all was well.

Indeed, UTI jumping into the fray in this manner is so disturbing that the JPC have particularly urged that:

> "the investigative agencies examine the telephone records of Shri P.S. Subramanyam and others concerned to ascertain who was in touch with whom on 9.3.2001" (para 18.18, p.400)

That investigation will surely open a whole can of worms!

Moreover, the Finance Minister had with him on 13.3.2001 the report on "Clearing & Settlement" presented to the CSE Committee by its executive director the previous day, 12 March, which stressed that CSE was still “assessing the situation". That it was apprehensive was revealed in its asking brokers for “early pay-in of securities/funds" and adding that smooth settlement was contingent on “after taking such measures" (para 6.14, p. 117). The JPC observes that neither the continuation of the payment problem nor its magnitude was appreciated by SEBI “as reflected in the interventions of the Finance Minister in the Rajya Sabha" (para. 6.18, p. 117).

Yashwant Sinha's fig-leaf is that he said what he said to Parliament because he was so assured by SEBI. But if SEBI did not ask the right questions of CSE, clearly the minister failed to ask the right questions of SEBI. Instead, he unquestioningly passed on to Parliament whatever was dished out to him by SEBI. Where circumspection was called for, the finance minister preferred to bail himself out with unverified assurances. It is for the Rajya Sabha to determine whether any question of privilege arises. As far as the JPC is concerned, their view is clear:

> “The CSE and erring brokers were let off the hook as early as 1994 which resulted in the payment crisis on CSE in March 2001. Both CSE and SEBI were lax in monitoring, surveillance, investigation and implementation. SEBI's actions were totally inadequate in dealing with irregularities...Had the action been prompt, many of the CSE's shortcomings could have been corrected on time" (para 3.29, p. 17).

The JPC goes on to observe:

> “Everyone concerned - the Ministry, the Regulator, CSE - ought to have seriously addressed themselves to the systemic deficiencies in CSE when its turnover was exponentially rising. They did not because, it would appear, no one was interested in intervening when the going was good" (para 6.19, p. 117).

“Everyone" includes Yashwant Sinha. He set the tone for no one intervening when the “going was good". Nor can he escape the responsibility for the Committee's “considered view":

> "that, at bottom, the payments crisis on CSE arose because the SEBI *in consultation with the Ministry of Finance* (emphasis added) had permitted the resumption of badla without arranging for curbing or regulating rampant off-market 'internal badla'." (para 6.19, p. 117)

The ethos in which SEBI functioned less as an independent statutory regulator than as a handmaiden of the Ministry of Finance is best illustrated by the manner in which SEBI swung into action when the market, after initially reacting favourably to the Finance Minister's Budget proposals for 2001-2002, reversed itself the following day and fell - a net fall of only a single sensex point. The JPC, at pages 199 to 200 of their Report, have analyzed whether there was any objective basis to SEBI's perception of "unusual market behavior inspite of a well-received Union Budget". The JPC have found (para 9.57 p. 199) that "market volatility in four months of the year 2000 (April, May, August and September) was higher than in February or March 2001." Yet that volatility had not awakened the sleeping Kumbakarnas of SEBI. The JPC have also found that "large falls had occurred at least 10 times in the previous year" and "the single day fall has been more on at least 125 days". Yet, none of this had occasioned in SEBI the concern that was felt when the market did not endorse the SEBI/ Government of India view of "a well-received Union Budget". Indeed, for the market to fall the day after the presentation of the Budget is routine. It has done so, as the JPC says, "on most occasions in the decade of the nineties". And in actual fact "the biggest fall - of 520 points - was recorded the day after the Budget was presented in 2000." But as February 2000 was the peak of the boom with the sensex touching 6000, SEBI was not stirred to an investigation.

Furthermore, the JPC have found that in selecting the entities to be investigated SEBI proceeded "on the assumption of a deliberate bear-hammering" and "did not take into account other signals of what going awry in the markets:

> "including the trouble brewing in CSE, the over-extended position of the Ketan Parekh Group, the withdrawal of large investments by FIIs, the non-redeployment of substantial funds by the largest ALBM operator and others, and problems world-wide on stock exchanges owing to market sentiments being disillusioned with ICE stocks, and the declining trends in sensex that had set in before the presentation of the Budget. This does not reflect well on the alertness of the Regulator to the happenings in the market" (para 4.4, p. 19).

All this should have been evident as much to the regulator as to the Ministry. Yet, the minister chose to repose his unquestioning faith in SEBI and felicitate it in the Rajya Sabha on having decided to go into "the whole gamut of issues". Instead, he should have pulled up SEBI for not having much earlier investigated the "gamut of issues" which together constitute this scam.

That investigation was launched only when SEBI got caught up in the Finance Minister's disappointment at market sentiment not reflecting government sentiment. A few brokers who had long been expressing apprehensions of the market being over-heated were targeted. Among them was First Global Stockbrokers Ltd, the brain-child of a remarkable couple, Shankar Sharma and Devina Mehra, who had made First Global into a world-recognised stock broker even on the New York Stock Exchange - a first for India and a reflection of the top professional expertise that is picked up in our best management schools, which is where Sharma and Mehra met, fell in love and got married.

In fact, in the period taken up in SEBI's initial investigation of “unusual market behaviour", First Global established that it was a net buyer, not a net seller and could not, therefore, be implicated in any “bear hammering", deliberate or otherwise. And there the matter might have ended but for the Tehelka scandal breaking on 13 March 2001 and the discovery that First Global was an “angel" investor in the dotcom start-up. That dished the couple. They have been subjected to relentless persecution ever since. But as far as the JPC is concerned, after spending more time on First Global than any other broker, even Ketan Parekh, and writing more lines about the interrogation of Shankar Sharma than on any other player, the JPC has concluded that:

> "SEBI has not so far provided conclusive evidence to substantiate its conclusions" (para 4.117, p.45)

Indeed as disturbing as the persecution of First Global is the manner in which SEBI targeted none but the bears - as if selling is an offence! In consequence, the initial list of entities to be investigated, determined by SEBI in consultation with the primary regulators, that is, the stock exchanges, did not include key players in the scam such as Ketan Parekh or, indeed, any bull broker. Nor did the list include Renaissance Securities, a prominent bear who appears to have redeemed himself by being associated with the chairman of SEBI in a Jaipur-based humanitarian enterprise. Also excluded inexplicably from the list of entities to be investigated were massive sellers like the foreign institutional investors and giant corporates like Reliance. They exited because they saw the market was poised on the precipice of a steep fall. Instead of seeing this truth staring them in the face, SEBI**,** reflecting the Ministry of Finance's perception of the budget, first lathered itself into a frenzy of excitement over the market rising 177 points in reaction to the Finance Minister's “9 out of 10" budget (the absurd assessment of one expert who ought to have known better) - and then drowned itself in the disappointment felt in North Block when the market returned within 24 hours to the downward trend that had been in evidence since mid-February.

Extraordinarily, SEBI's investigation did not take into account the emerging payments crisis in the Calcutta and National Stock Exchanges. Shockingly, SEBI's director on the CSE did not even care to go, nor was ordered to go, to Kolkata to exercise on-the-spot regulatory vigil at the nadir of the crisis (para. 6.13, p.116. See also paras 3.24 ad 3.25 at p.16). Indeed, SEBI did not even ask why UTI was involving itself in bailing out CSE even when the UTI executive director concerned brazenly announced on 9 March 2001 to the media in Mumbai, where SEBI is headquartered, that UTI was intervening to ensure settlement on CSE. It was the apprehension of a payments crisis on CSE, triggered by brokers associated with Ketan Parekh's over-extended position, which most persuaded the big investors, from mid-February 2001 on, to pull out of the market before it took them down. Yet, the SEBI investigation excluded CSE from the ambit of the entities to be investigated! As already noted, the connection between Reliance's non-deployment of their funds in ALBM and the payments problem on NSE (happily resolved without dipping into reserves) also caused no concern to SEBI's enquiry into why the marker was falling “inspite of a well-received Budget". Such was the quality of SEBI's market intelligence and such was the state of knowledge of Yashwant Sinha and his ministry.

The “dissonance" in approach to regulation as between when the market was booming and when it was falling was clearly the consequence of u system of governance in

which hands were kept off when the going WUN good and scapegoats were chased when things went from bad to worm The Governor of the Reserve Bank of India admitted to (he JPC:

> “I would honestly say that maybe that one likes the Hull inn mill one does not like the Bear run and, therefore, you always react to adversity and not to good fortune." (para.9.65, p.201)

That may be an honest confession but it is also the admission of a collapse of good governance. If regulators were behaving in this manner, it was for the Minister of Finance to have brought them back on track. For, as the JPC points out (para 9.55, p 199):

> "It is evident that SEBI suspected something might be wrong but, for fear of being held responsible for pricking the balloon, decided to go along".

Regulators and the Ministry of Finance: RBI

The Reserve Bank of India's performance as the Regulator of the banking system was no better than SEBI's as the regulator of the stock market:

> “instances of regulatory laxity in the present scam are the result of delay by the RBI in following up its own inspection and observations on the functioning of banks' operations. It is also noticed by the Committee that RBI seemed content with the routine replies of the banks concerned. There appears to have been a lack of concern and absence of strict action till matters went out of hand" (para 3.22, p.16).

The JPC have severely indicted RBI for a whole host of deficiencies:

- both external audit and RBI supervision have been “weak and ineffective" (para 10.8, p.225);
- failure to appoint auditors for “months together" (para 10.9, p.226);
- repeated failure of RBI-nominated directors to take their duties “seriously or conscientiously" (para 10.14, p.227);
- failure to ensure “uniformity of regulation so that the impartiality of the regulator is recognized by all" (para. 10.22, p.230);
- failure to “have anticipated the possibility of the diversion of funds and taken pre-emptive action to forestall it" instead of waiting for “a loophole to be exploited before closing it" (para 10.31, p.232); and
- failure to “effectively supervise" urban cooperative banks notwithstanding "the huge increase in the number of UCBs, the huge size of their deposits and their increasing involvement, overtly and covertly, in stock market operations well before the scam" (para 10.58, p.239).

The last point needs stressing. The Madhavpura Mercantile Cooperative Bank and Ketan Parekh would not have been able to sustain their nexus so long if the Bombay Stock Exchange branch of the Bank of India had not been so generous with discounting facilities as it became, especially -perhaps coincidentally - after the appointment of one Shri U. Somaiyya to head the branch (para 5.55, p.66 and 5.165 and 5.167, p.91). Week after week, settlement of Madhavpura's Bol-discounted pay orders was effected in the Brihanmumbai Bankers' Clearing House run by RBI without anyone in RBI

querying how it was that pay orders were being issued repeatedly by MMCB to KP group companies far in excess of the net worth of Madhavpura (paras 5.160-5.161, p.90). Nor did RBI put two and two together in examining Call Money market returns which showed both Ketan Parkeh and Madhavpura as unusually large borrowers on the Call Money market (Appendix VI, cf. para 5.9(x), p.56). Indeed, the Madhavpura-KP angle to the scam surfaced only when on 12.3.01, with retrospective effect from 9.3.01, RBI stopped payment of a pay order of Rs.137 crore illegitimately issued by Madhavpura in favour of Ketan Parekh, which had been discounted by the BSE branch of the Bank of India (para 5.11(ii), p.57,5.28, p.60,5.55, p.66 and 5.162-5.165, pages 90-91). Such action much earlier in the game would have prevented the recycling of the scam. The .IPC observes that RBI (and SEBI) need to:

> “draw the right lessons from the regulatory point-of-view to put in place an integrated system of alerts which would piece together disparate signals from different elements of the market to generate special attention to any unusual activity anywhere in the system which might have a bearing on the integrity of the stock market" (para 5.55, p.66).

The scam would not have occurred if SEBI or RBI or both, or the High Level Coordination Committee, chaired by Governor, RBI and serviced by the ministry of finance, had been a little alert to what was going was when the going was apparently good. That the finance ministry did next to nothing to chivvy the regulators is testimony alike to the incompetence and impotence of the ministry and the minister who headed it.

Indeed, instead of looking within, RBI, as soon as the scam became public knowledge, started its witch-hunt. A flurry of activity was manufactured to give a semblance of real concern to RBI regulation. Private sector banks, in particular Global Trust, were paraded as the bad boys. But, as the JPC concludes, “there were no violations of any prudential norms" by GTB. That was for the good reason that RBI’s norms were so lax that

> "It was only recently in May 2001 when fresh guidelines have since been issued by RBI and the banks' exposure to capital markets has been further regulated" (para.5.157, p.89).

As detailed at pages 95-101, and summarised at para 5.196, p. 102, the Nedungadi Bank chairman was ordered by RBI to demit office for having implemented a scheme for unauthorised arbitrage operations which was “misused by a few brokers who alone had a turnover of about Rs.1350 crore to their sole advantage during the relevant period". They got away with the scam because RBI "did not take timely notice of this irregularity"; "instead of stopping the scheme immediately, the RBI took their time and did not take prompt decision"; and "Even when the Board was informed of the arbitrage transactions, the RBI's nominee Director did not raise the question of suspending" the transactions. Moreover, the RBI representative "did not place the correct facts" before the JPC. “There was an attitude of total apathy on the part of the RBI." Yet, it is the chairman of Nedungadi Bank who was sacked. Governor, RBI is exactly where he was, and the RBI's nominee-director continues her rise up the regulatory ladder!

The JPC enquiry into the commercial banks targeted by RBI has turned up much that was improper but almost all of which was legal largely because RBI and the Ministry of Finance failed to close the regulatory loopholes through which the nexus of banks, brokers and corporates had slipped. Attention has already been dawn to the virtual

closing down of the special cell set up by Dr. Man Mohan Singh to investigate the nexus (para 2.19, p. 10, para 2.21, p.ll, paras 3.12-3.14, p.14, and para 7.3, p.146). Worse, so fragmentary is the knowledge of the regulators - RBI, SEBI and the Department of Company Affairs - of the relationship between banks, brokers and corporates that even after 20 months of sittings of the JPC, the regulators failed to report on the facts of the matter, leaving the JPC, which is *not* an investigative body, with no alternative but to mourn “their inability to take oral evidence" of the corporate bodies concerned (para 7.51, p. 164). In consequence, the JPC have not been able to make “any purposeful recommendations" in regard to exposing and breaking the nexus (para. 7.54, p. 164) although “facts have come to light (which) establish the nexus between brokers and corporate entities" aimed at “enticing innocent participants in the stock market" to purchase certain scrips by “creating an impression that the scrip in which circular trading is effected was heavily traded" (para 7.4, pages 146-147).

The regulatory loopholes left unplugged included numerous legislative proposals on which the ministry and/or the regulator dragged their feet (paras 10.69-10.72, pages 242-243, paras 10.75-10.76, p.245, andparal3.31, p.316). "RBI has been rather tardy," says the JPC, "in suggesting amendments to existing legislative provisions to make them stronger and more punitive" (para 10.76, p.245) and the Committee have had to "deplore the delays in Government in processing legislative changes proposed by RBI with the dispatch that they deserve" (para 13.31, p.316).

> “That these amendments had to wait for a second major scam to break reveal the petering out, within months of the ATRS, of the will of the Government to implement the required systemic changes" (para 10.72, p.243).

These loopholes are now being closed - sometimes with worrisomely excessive zeal (cf. para 10.36, p.234). The question which remains is: why was such action was not taken in boom times with all deliberate speed? The answer quite evidently is that the "feel good" factor took precedence in the Ministry's priorities over the integrity of the market. Hence, the scam.

A particularly striking instance of shoddy regulation was RBI's request to SEBI on 24 November 2001 to investigate press reports relating to the rise in share prices of Global Trust Bank (GTB). These reports, says the JPC′, "turned out to be incorrect in important particulars". Contradicting Governor, RBI’s claim before the JPC that such requests were routinely made every time share prices of banks rose unusually, especially in the context of merger proposals, the JPC have found:

> “RBI did not act in a similar manner when share prices were going up much faster of several other banks in the comparable period of time, not even of the Bank of Madura whose share prices on the eve of its merger with ICICI Bank rose even higher than those of GTB" (para 10.22 (c), pages 229-230).

RBI have, therefore, had to be cautioned by the JPC that “there must be uniformity of regulation so that the impartiality of the Regulator is recognized by all." Clearly this was not the case in RBI’s hunt for scapegoats after the scam broke.

The JPC has focused on the diversion of funds as a key contributor to the scam (pages 231-234 and para 10.84, p.248). “Diversion" refers to corporates/brokers taking loans or lines of credit from banks for specified purposes and then diverting the funds to

other purposes for which the law or regulations will not permit the real end-user to access bank funds. Thus, a corporate entity is not allowed to secure bank financing to jack up the prices of its own shares. Yet, the regulatory mechanism could not effectively check corporates diverting bank funds to brokers to do the jacking up of shares in which they were interested. Nor is it legitimate for bank financing to be diverted to assist brokers out of their financial difficulties. That there was rampant diversion of bank funds was not even denied before the JPC. It was explained, however, that banks are not in a position to track the end-use of funds. Moreover, the JPC was told, there is nothing illegal about such diversion. Governor, RBI bluntly admitted that the system of RBI regulation of the end-use of funds had been rendered "non-functional" (para 10.76, p.245). The JPC comes down heavily on this:

> "The Committee regret that knowing fully well the ineffectiveness of the extant system in preventing the diversion of funds, RBI should not have taken before the scam broke the steps they have so assiduously put in motion after the scam" (para 10.31, p.232)

and

> "The Committee deplore the half-hearted and casual manner in which these critical matters have been dealt with and desire that proposals already forwarded by the RBI to the Ministry be cleared expeditiously" (para 10.76, p.245)

Had "timely action" been taken "much earlier" on the issues raised in the Kohli Working Group, concludes the JPC, "such pre-emptive action could have forestalled, or at least moderated, such diversion" (para 10.38, p.234). Now in a panic to cover their tracks, such drastic measures have been introduced against diversion (yet another instance of bolting the stable door after the horse has fled) that the JPC have been constrained to remark with reference to the recommendations of the Kohli Working Group which, after the scam, has studied and made recommendations relating to tracing end-uses to prevent diversion:

> "The Committee recommend that RBI should constantly review the feasibility of implementing these guidelines" (para 10.36, p.234)

The Mauritius Route and the Ministry of Finance

It is in leaving the Mauritius Route entirely unregulated, despite Mauritius having emerged during his period as Finance Minister as the single most important source of foreign institutional investment in our capital markets, that the Minister and the Ministry he ran, are most severely to be indicted. The JPC Report devotes an entire chapter to this, spread over 21 pages (165-186). Indeed, it is highly significant that the numerous companies registered in Mauritius by the Ketan Parekh group soon after Mauritius passed its Off-shore Business Activities Act in 1992, did not become active in the Indian market till Yashwant Sinha made it abundantly clear during the 1999-2000 boom that he was deliberately looking the other way (p.174). The numerous improprieties perpetrated through the Mauritius route have been recounted in detail at pages 167 to 179 and summarized at pages 180 to 182 of the Report. These include:

- "several instances of non-adherence to RBI guidelines" and "several

instances of violations of SEBI regulations" by Overseas Corporate Bodies (OCBs) and sub-accounts of Foreign Institutional Investors (FIIs);

- these have particularly occurred in certain scrips associated with Shri Ketan Parekh";
- they have “aided, assisted and abetted in creation of artificial markets and volumes";
- this has also led to “more outflow than inflow of funds";
- there has been no monitoring by RBI of “compliance of its guidelines regarding OCBs";
- nor by RBI/SEBI of the “purchase of shares of their own companies by Indian promoters" through the illegitimate if not illegal dodge of “Participatory Notes issued by sub-accounts of FIIs";
- and all this was left unregulated although, as SEBI reported to the Committee, “more than 80 percent of OCBs are registered in Mauritius and some of them seem to act as front for promoters of certain Indian companies."

Moreover, nothing was done to regulate, or even carefully monitor, this route notwithstanding the exponential increase in its significance for our financial and capital markets:

> "OCBs are neither registered nor regulated by SEBI nor are they required to furnish information in respect of transactions to SEBI" (para 8.50, p. 176)

> "Let me say, “said Chairman, SEBI, "that OCBSs are not our babies" (para 8.63, p. 178)

Nor, apparently were they the RBI's. RBI now accept that “many of these OCBs are dummy companies associated with Indian companies and some of these have resulted in nexus between the two" (Governor, RBI's statement, para 8.52, p. 177). This happened because instead of itself monitoring RBI regulations in respect of OCBs, this was left to the “designated bank" (para 8.54, p. 177). The JPC have found this “inadequate" (8.55, p. 177).

As for the HLCC, it is evident from Governor, RBI's reply to the question “whether at any point of time the question of who should control the OCBs was discussed in the HLCC", of which he was chairman, (para 8.53, p. 177) that the subject came for the first time only on 12.9.2001, after the scam had surfaced and only because the JPC had started asking searching questions.

The JPC have, therefore, had to “note with concern" that:

> "The Ministry of Finance did not adequately address itself to issues relating to the Mauritius route notwithstanding the growing impact of this Mauritius route on our capital market over several years" ara.8.79, p.181).

The Ministry of Finance should have established "a regulatory framework to monitor the activities of OCBs", but:

> "The Ministry of Finance, being the main policy-making body, has not applied their mind in this regard"

and, therefore, now that the damage has been done, the JPC can only recommend that:

> "the Ministry of Finance needs to lay down clear policy guidelines for monitoring the operations of OCBs" (para 13.56, p.322)

Policy-making is, of course, the preserve of the Minister. If policy was not made, the responsibility vests in the minister.

After detailing, at pages 182 to 186, the hectic diplomatic interaction between the Governments of India and Mauritius in the period covering the Prime Ministerships of P.V.Narasimha Rao and H.D.Deve Gowda, the JPC have contrasted this with the fact that "virtually no action was taken" after February 1997 "to raise and pursue these concerns" with the Mauritus authorities. These concerns included "money-laundering by Indian companies". Particularly damning is the JPC's observation that notwithstanding the offer made to the Indian Finance Minister by the Mauritius minister in March 2000 to address "Indian concerns of recent origin", "little or nothing was done in the Ministry *or by the Minister* (emphasis added) to raise these issues with Mauritius". "Indian concerns of recent origin" related to "misuse of the route (which) appears to have been significantly responsible for market manipulations during the boom of 1999-2000 which led to the bust of 2001." It was negligence of this order which failed to "prevent scams of the kind that occurred in 1999-2001 when due attention was not being paid to the dangers inherent in the virtually unregulated Mauritius route" (para. 8.97, p.186).

It was a failure of both financial regulation and diplomacy. Yet, Yushwant Sinha has been rewarded for his failures in finance by being entrusted now with diplomacy!

II-Unit Trust of India/US-64 Imbroglio

US-64; Lighting the dark

On 2 July 2001, a stunned nation learned that the Unit Trust of India's flagship mutual fund scheme, US-64, which had emerged since 1964 as the most trusted instrument for the investment of small household savings, had betrayed the trust of the people. For the first time in nearly four decades of its existence, UTI failed to declare a dividend and froze all redemptions for six months. At least 2 crore and possibly up to 3 crore investors, affecting approximately 15 crore middle-class Indians, constituting over half of all those in the country who have the capacity to save, were robbed of their hard-won savings for no fault of their own.

In response to the public outcry, Government quickly agreed to add UTI to the mandate of the JPC which had already started functioning.

Meanwhile, Yashwant Sinha dismissed the chairman of UTI, PS. Subramanyam, for having kept everybody, including the ministry and the minister, “deliberately in the dark". Sinha told the Rajya Sabha that Subramanyam had "repeatedly" assured him through his ministry that everything was “hunky-dory" at UTI and its hugely popular US-64 scheme. Was Subramanyam alone to blame?

The JPC have regretted that:

> “The culture of governance continues to be pervaded by attempts at transferring responsibility elsewhere" (para 13.47, p.320)

No one has been more steeped in the culture of transferring responsibility elsewhere than Yashwant Sinha. And nowhere has he been more guilty of this than in the reasons he has given for summarily dismissing the former Chairman of the UTI. The background to this dismissal has been recounted in great detail at pages 380-386 of the JPC report, which establishes that:

- Far from having “repeatedly" interacted with Subramanyam I the period April-end June 2001, there was in fact only one written communication to the Ministry from the Chairman, a letter dated 18.5.2001. No attempt was made by the Ministry or the Minister through the months of May and June 2001 to speak to Subramanyam on the telephone or to meet him in person. The minister claimed before the JPC that he had “repeatedly" instructed his officers to contact chairman, UTI. The JPC have established that the minister's instructions were ignored or not in fact given. Either way, there is no basis for the calumny that the chairman “repeatedly" assured Sinha that all was “hunky-dory".

- “No analysis," says the JPC, “was made in the Ministry of the Chairman's letter of 18.5.2001." The letter itself was treated as an FR (Fresh Receipt) "requiring no more than perusal without analysis or follow-up" (para. 17.22, p.388). “There is no summary, assessment or analysis of that communication in the notes or correspondence section of the file." (para. 17.21, p.385). The JPC goes on to say: "Chairman UTI's letter of 18.5.2001 was put up to FM as FR for information but *FM's orders were neither sought nor given"* (emphasis added). Indeed, the treatment of this letter was so casual that the file itself was constituted only after the Chairman was dismissed.

- As regards the contents of the letter of 18.5.2001, it says the US-64 scheme will be able to give a dividend and maintain a reasonable post-dividend net asset value only “if the sensex reaches around 4300 level" by June-end. (2 years after the crash, sensex is still hovering a around 3000!) The letter further says, “there is an expectation of about 20 to 25 per cent raise in the sensex by 30 June 2001." (There was, in fact, no rise at all). These were ridiculous assumptions, and, unsurprisingly, as the JPC notes:

  'the following notations were made in the margin against these two quotes respectively: “?” and “?!!’”

- Yet, although the absurdity of the assumptions was clear enough to the Ministry official who made these notations, the Minister told the JPC: “when I looked at the assumptions in the letter, there was nothing fairly dramatically unusual about it." Extraordinary that what occasioned incredulity in the Ministry, as is evident from the notations, was not found "fairly dramatically unusual" by the Minister! Was it Subramanyam who was pretending that everything was “hunky dory" - or was it Yashwant Sinha hoping against hope that everything would indeed turn out “hunky-dory"?

- No wonder the JPC concludes:
  "Even if Chairman, UTI did indeed keep everybody in the dark, as FM told the Rajya Sabha, the Committee find that the Ministry did little to bring itself out of the darkness" (para 17.22, p. 388)

- Scoring the Ministry for not having "instituted any formal mechanism to keep itself informed about then health of the US-64 scheme," the JPC point out that:

"Autonomy in day-to-day management of the UTI cannot absolve the Ministry of its statutory responsibilities and accountability to Parliament"

(para 17.22, p.388).

It is not Chairman UTI or the officials of the Ministry but the Minister and none but the Minister who is responsible to and accountable to Parliament. As the JPC have stated in their Chapter on the Ministry of Finance:

> "accountability must go hand-in-hand with autonomy and the principles governing the responsibility of the Minister to Parliament in terms of the Constitutional jurisprudence under which the parliamentary system works." (para. 13.46, p.320)

UTI and the Ministry of Finance

Hence, Yashwant Sinha just cannot escape his responsibility to the Parliament and the country for all that went wrong with UTI and US-64, as detailed by the JPC over nearly 100 pages of its Report (339-426). Among the various things that went wrong or were not set right over the period from March 1998 when Yashwant Sinha became Finance Minister, the following may be particularly underlined:

- Although "1993 onwards successive governments very well realised that UTI had to be revamped",

  > "lack of urgency in successive governments, abetted by self serving and negligent management in UTI *and inertia in the Ministry of Finance*, undermined a public financial institution by directing its investment and lending decisions in favour of dubious private sector promoters in the name of reviving capital markets, ignoring the fact that the purpose of UTI was to serve the interest of unit holders" (para 15.9, pages 341-342, emphasis added)

- "complete lack of transparency and accountability" in taking investment decisions owing to "the extent of discretion vested in the chairman and executive committee" (para 16.12, p.347), a discretionary power not subject, astonishingly, to either statutory or other scrutiny (para. 16.5, p.344). This led to Parliament's Standing Committee drawing the attention of the ministry and, therefore, the minister to "undesirable and unhealthy practices" (para 16.7, p.345). So, the Ministry of Finance was "aware of the extent of authority and its exercise". This, says the JPC:

  > "should have persuaded the Government to intervene in the affairs of UTI keeping in mind the public interest, especially the interest of the ordinary unit holders whose small investments were thus put in jeopardy" (para 16.12, p.347)

- Moreover, with regard to the need for drastic change in UTI, evident since the Vaghul Committee report of 1993 and underlined by the Deepak Parekh

Committee report of 1998-99, “the Ministry of Finance too must bear the responsibility for tardy action" (para 17.12, p.377). “UTI dragged its feet in implementing necessary organizational changes" and:

> "the Ministry of Finance should have been more pro-active in bringing the required legislative changes and bringing home to UTI through its frequent interaction with UTI the need for a radical overhaul in UTI's investment policies and decision-making mechanisms" (para 16.14, p.347)

The Minister did not do so. The only possible reason could be that he did not

wish to do so.

- Several other acts of omission and commission by UTI and its chairman, including massive, repeated and motivated inter-scheme transfers to disguise the true state of affairs in UTI; failure to “formalize a comprehensive investment policy" leading to "decisions detrimental to the interests of UTI and its investors" (investments in DSQ Sofware, Numero Uno International and Cyberspace Infosys have been the particular spotlight of attention, the latter involving possibly “extraneous considerations" which need investigation); the absence of a “proper risk management system in secondary market operations"; irresponsibility with regard to assured return schemes etc., detailed at pages 348-368.

- Also, several acts of omission and commission involving the Ministry of Finance and, therefore, its Minister. These included the evolution of UTI into a hybrid institution which undertook both mutual fund and banking/term-lending activities leading to “distortion as far as UTI as a mutual fund was concerned" and a “mismatch problem" (pages 368-371). Notwithstanding the Deepak Parekh Committee's key recommendation with respect to US-64, namely, reversing the debt-equity ratio from about two-third debt and one-third equity to the opposite, UTI actually increased the share of equity in US-64 between 1998 and 2001 (para 17.17, p.380).

- The Ministry of Finance did nothing substantive or effective about ensuring that UTI reduced the risk factor inherent in equity holdings. In consequence, when the market collapsed from a high of 6000 in February 2001 to half that level a year later, UTI was stranded with huge losses in equity values. It has cost this country some Rs 15000 crore to put US-64 back on his feet.

- Other shortcomings in the ministry living up to its responsibility to Parliament and the country for the well-being of UTI and US-64 have been detailed pages 418-426, leading the JPC to conclude that:

> "since the US-64 scheme was not subject to SEBI guidelines, was not NAV based, had a large investor base and had been bailed out earlier, the Ministry of Finance should have been more pro-active in devising a formal mechanism., .to monitor the health" of US-64 (para 20.14, p.525).

- in the event, “when the stock market showed volatility, the share prices fell steeply and the US-64 scheme faced liquidity problems due to redemption pressure", the Ministry failed to deal “promptly" with the crisis (para 20.14, p.525).

The Ministry and the Minister

The JPC says:

> "The Ministry of Finance, being the financial custodian of the country, is duty bound to protect the interest of the small investors"
>
> (para 13.48, p.320).

Yashwant Sinha is guilty of having failed "to protect the interest of the small investors". Unless punishment starts at the top, there can be no systemic overhauling of governance or management.

Yashwant Sinha must pay for his sins.

So must Arun Jaitley.

And the Prime Minister must make suitable amends for the patronage extended to the likes of the Johari brothers.
Other wise we will continue our dreary slide from stodgy socialism to crony capitalism.