

# Markets | SEBI orders in NSE co-location case have loopholes, leave questions unanswered

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Last week, in a series of orders, the Securities and Exchange Board of India (SEBI) has charged the National Stock Exchange of India (NSE) and certain officials with providing unfair access to bourse's co-location facility to some trading members, corporate governance violations, providing dark fibre/leased line connectivity to certain trading members and so on.

The orders are a result of a long-drawn out investigation after a whistle blower complained to the markets regulator in 2014-15. However, the orders are still wanting on many counts; they haven't fully determined ill-gotten profits, they haven't examined SEBI's own mechanism to review systems of stock exchanges even when it does periodic inspections, and they haven't streamlined the process of dealing with growing whistle blower complaints in regulatory enforcement. It is unknown how disgorgement is going to be used to compensate the victims, if they are identifiable. In some instances, SEBI seems to have inflicted self-goals, passed creative directions and it is unlikely that they will stand up to the test of legal scrutiny.

### **Issues in the co-location order**

In the co-location matter, SEBI has not been able to find sufficient evidence to conclude that NSE has violated the regulator's unfair trade practices regulations. However, SEBI said that there was enough evidence to show that NSE did not exercise the requisite due diligence while putting in place the TBT (tick-by-tick) architecture. In other words, NSE failed in its primary duty as an exchange to ensure equal and fair access to all trading members. Accordingly, SEBI has banned NSE from accessing the securities markets for 6 months (essentially postponing its initial public offer), directed the exchange to disgorge Rs 625 crore (with 12 percent this becomes close to Rs 1000 crore), and asked the bourse to initiate an inquiry under its Employees Regulations against two employees for failing to discharge their duties.

There are several issues here. One, while the penalty for NSE seems large at Rs 1000 crore note that it is only about half of the Rs 1,994.77 crore revenues earned from co-location (and disclosed in quarterly results) that were kept in an escrow account pending investigation. Two, SEBI's order seeking an inquiry tells NSE to "fix(ing) accountability on the employees." That prejudices the outcome of such an inquiry at NSE.

Moreover, in an unprecedented move, SEBI has asked Ravi Narain and Chitra Ramkrishana, both former MDs and CEOs, to disgorge 25 percent of their salaries from the financial years 2010-11 to 2012-13 and 2013-14 respectively to its investor education and protection fund. There are questions about the applicability of clawback provisions (contrary to standards applicable in service law) as also the lifting the corporate veil to determine vicarious liability when no case of fraud has been established. It is unusual and SEBI needs to resist passing creative directions.

### **Corporate governance and the Ajay Shah issue**

A related issue was that of NSE providing some data to Ajay Shah and Infotech Financial Services to create a liquidity index. This said data was alleged to have been misused for developing commercial algorithm-based trading software.

SEBI's order held that Narain and Ramkrishna overlooked conflicts of interest, were negligent, and did not ensure fairness and transparency. It said that NSE provided this data without initially even putting in place a policy to share data. The order noted that Infotech was not even

trying to recover the fees payable to it by NSE which made it clear to SEBI that gaining access to the exclusive data was the key consideration for the company.

That said, the order also confirmed that there was no concrete evidence to establish collusion of NSE with Ajay Shah or Infotech in their plan to misuse the data. Ajay Shah, Infotech, and certain officials of NSE have been barred from accessing the markets for certain periods of time.

All that is well, but from a legal standpoint, it is rare for a regulator to enter into a private agreement between the parties to the contract, and determine its breach and ask for its enforcement by one of the parties. Could a statutory power be used to repudiate a contract, which itself is not regulated by the regulator?

SEBI's contention seems to be that when a data sharing agreement meant purely for research "assumes the colour" of a commercial agreement and a few people exploit this privileged data, it "leads to serious issues leading to compromise of market integrity." But does it prove that SEBI's fraudulent and unfair trade practice regulations have been breached? That will be the order's litmus test when it is appealed at the Securities Appellate Tribunal.

### **OPG and the dark fibre**

There are some issues from a legal standpoint in the order pertaining to OPG which is alleged to have gained preferential and unfair access to tick-by-tick data.

SEBI calculated that OPG Securities made unlawful gains of Rs. 15.57 crore, which it has been directed to disgorge along with interest. OPG has also been held to have violated SEBI regulations on prohibiting fraudulent and manipulative practices as well as the **Code of Conduct applicable to a Stock Broker**.

SEBI has not only prohibited OPG from accessing securities in its proprietary account for five years, but also not take any new clients for one year in its capacity as stock broker, both from the date of the order. Firstly, it is perplexing how an order inflicting sanctions is implemented immediately vitiating a right to appeal. Later, pending an appeal at SAT, SEBI comes up with a relaxing order to allow the broker to close out its open positions in the market. From a strategic point of view, SEBI committed - an error, if not *hara kiri* - by passing an addendum order and loosening its stand, just two days after passing the final order.

### **Conclusion**

It is unfortunate that this episode has questioned the credibility of stock exchanges and the way information is stored, reviewed, and shared, notwithstanding the regulatory review of Ministry of Finance and SEBI. However, what's more perplexing is the loopholes in some of the orders as mentioned earlier.

While some parties have approached SAT and have also obtained interim relief, the complete story of unequal colocation and unfair access remains a mystery.

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