A Case Study on *Ketan Parekh* Scam

The Crash that Shook the Nation

The 176-point Sensex crash on March 1, 2001 came as a major shock for the Government of India, the stock markets and the investors alike. More so, as the Union budget tabled a day earlier had been acclaimed for its growth initiatives and had prompted a 177-pointincrease in the Sensex. This sudden crash in the stock markets prompted the Securities Exchange Board of India (SEBI) to launch immediate investigations into the volatility of stock markets. SEBI also decided to inspect the books of several brokers who were suspected of triggering the crash. Meanwhile, the Reserve Bank of India (RBI) ordered some banks to furnish data related to their capital market exposure. This was after media reports appeared regarding a private sector bank having exceeded its prudential norms of capital exposure, thereby contributing to the stock market volatility. The panic run on the bourses continued and the Bombay Stock Exchange (BSE) President Anand Rathi's (Rathi) resignation added to the downfall. Rathi had to resign following allegations that he had used some privileged information, which contributed to the crash. The scam shook the investor's confidence in the overall functioning of the stock markets. By the end of March 2001, at least eight people were reported to have committed suicide and hundreds of investors were driven to the brink of bankruptcy. The scam opened up the debate over banks funding capital market operations and lending funds against collateral security. It also raised questions about the validity of dual control of co-operative banks. (Analysts pointed out that RBI was inspecting the accounts once in two years, which created ample scope for violation of rules.) The first arrest in the scam was of the noted bull, Ketan Parekh (KP), on March 30, 2001, by the Central Bureau of Investigation (CBI). Soon, reports abounded as to how KP had singlehandedly caused one of the biggest scams in the history of Indian financial markets. He was charged with defrauding Bank of India (BOI) of about $30 million among other charges. KP' s arrest was followed by yet another panic run on the bourses and the Sensex fell by 147points. By this time, the scam had become the 'talk of the nation,' with intensive media coverage and unprecedented public outcry.

The Man Who Triggered the Crash

KP was a chartered accountant by profession and used to manage a family business, Securities started by his father. Known for maintaining a low profile, KP's only dubious claim to fame was in 1992, when he was accused in the stock exchange scam. He was known as the 'Bombay Bull' and had connections with movie stars, politicians and even leading international entrepreneurs like Australian media tycoon Kerry Packer, who partnered KP in KPV Ventures, a $250 million venture capital fund that invested mainly in new economy companies. Over the years, KP built a network of companies, mainly in Mumbai, involved in stock market operations. The rise of ICE (Information, Communications, and Entertainment) stocks all over the world in early 1999 led to a rise of the Indian stock markets as well. The dotcom boom contributed to the Bull Run led by an upward trend in the NASDAQ. The companies in which KP held stakes included Amitabh Bachchan Corporation Limited (ABCL), Mukta Arts, Tips and Pritish Nandy Communications. He also had stakes in HFCL, Global Tele systems (Global), Zee Telefilms, Crest Communications, and Penta Media Graphics KP selected these companies for investment with help from his research team, which listed high growth companies with a small capital base. According to media reports, KP took advantage of low liquidity in these stocks, which eventually came to be known as the 'K-10' stocks. The shares were held through KP's company, Triumph International. In July 1999, he held around 1.2 million shares in Global.KP controlled around 16% of Global's floating stock, 25% of Aftek Infosys, and 15% each in Zee and HFCL. The buoyant stock markets from January to July 1999 helped the K-10stocks increase in value substantially (Refer Exhibit I for BSE Index movements). HFCL scored by 57% while Global increased by 200%. As a result, brokers and fund managers started investing heavily in K-10 stocks. Mutual funds like Alliance Capital, ICICI Prudential Fund and UTI also invested in K-10 stocks, and saw their net asset value soaring. By January 2000, K-10 stocks regularly featured in the top five traded stocks in the exchanges (Refer Exhibit II for the price movements of K-10 stocks). HFCL's traded volumes shot up from 80,000 to 1,047,000 shares. Global's total traded value in the Sensex was Rs 51.8billion. As such huge amounts of money were being pumped into the markets, it became tough for KP to control the movements of the scrips. Also, it was reported that the volumes got too big for him to handle. Analysts and regulators wondered how KP had managed to buy such large stakes.

The Factors that Helped the Man

According to market sources, though KP was a successful broker, he did not have the money to buy large stakes. According to a report, 12 lakh shares of Global in July 1999 would have cost KP around Rs 200 million. The stake in Aftek Infosys would have cost him Rs 50 million, while the Zee and HFCL stakes would have cost Rs 250 million each. Analysts claimed that KP borrowed from various companies and banks for this purpose. His financing methods were fairly simple. He bought shares when they were trading at low prices and saw the prices go up in the bull market while continuously trading. When the price was high enough, he pledged the shares with banks as collateral for funds. He also borrowed from companies like HFCL. This could not have been possible out without the involvement of banks. A small Ahmedabad-based bank, Madhavpura Mercantile Cooperative Bank (MMCB) was KP's main ally in the scam. KP and his associates started tapping the MMCB for funds in early 2000. In December2000, when KP faced liquidity problems in settlements he used MMCB in two different ways. First was the pay order route, wherein KP issued cheques drawn on BOI to MMCB, against which MMCB issued pay orders. The pay orders were discounted at BOI. It was alleged that MMCB issued funds to KP without proper collateral security and even crossed its capital market exposure limits. As per a RBI inspection report, MMCB's loans to stock markets were around Rs 10 billion of which over Rs 8 billion were lent to KP and his firms. The second route was borrowing from a MMCB branch at Mandvi (Mumbai), where different companies owned by KP and his associates had accounts. KP used around 16 such accounts, either directly or through other broker firms, to obtain funds. Apart from direct borrowings by KP-owned finance companies, a few brokers were also believed to have taken loans on his behalf. It was alleged that Madhur Capital, a company run by Vinit Parikh, the son of MMCB Chairman Ramesh Parikh, had acted on behalf of KP to borrow funds. KP reportedly used his BOI accounts to discount 248 pay orders worth about Rs 24 billion between January and March 2001. BOI's losses eventually amounted to well above Rs 1.2 billion. The MMCB pay order issue hit several public sector banks very hard. These included big names such as the State Bank of India, Bank of India and the Punjab National Bank, all of whom lost huge amounts in the scam. It was also alleged that Global Trust Bank (GTB) issued loans to KP and its exposure to the capital markets was above the prescribed limits. According to media reports, KP and his associates held around 4-10% stake in the bank. There were also allegations that KP, with the support of GTB's former CMD Ramesh Gelli, rigged the prices of the GTB scrip for a favourable swap ratio before its proposed merger with UTI Bank. KP's modus operandi of raising funds by offering shares as collateral security to the banks worked well as long as the share prices were rising, but it reversed when the markets started crashing in March 2000. The crash, which was led by a fall in the NASDAQ, saw theK-10 stocks also declining. KP was asked to either pledge more shares as collateral or return some of the borrowed money. In either case, it put pressure on his financials. By April 2000, mutual funds substantially reduced their exposure in the K-10 stocks. In the next two months, while the Sensex declined by 23% and the NASDAQ by 35.9%, the K-10stocks declined by an alarming 67%. However, with improvements in the global technology stock markets, the K-10 stocks began picking up again in May 2000. HFCL nearly doubled from Rs 790 to Rs 1,353 by July 2000, while Global shot up to Rs 1,153. Aftek Infosys was also trading at above Rs 1000.In December 2000, the NASDAQ crashed again and technology stocks took the hardest beating ever in the US. Led by doubts regarding the future of technology stocks, prices started falling across the globe and mutual funds and brokers began selling them. KP began to have liquidity problems and lost a lot of money during that period. It was alleged that 'bear hammering' of KP's stocks eventually led to payment problems in the markets. The Calcutta Stock Exchange's (CSE) payment crisis was one of the biggest setbacks for KP. The CSE was critical for KP's operation due to three reasons. One, the lack of regulations and surveillance on the bourse allowed a highly illegal and volatile Badla business (Refer Exhibit III). Two, the exchange had the third-highest volumes in the country after NSE and BSE. Three, CSE helped KP to cover his operations from his rivals in Mumbai. Brokers at CSE used to buy shares at KP's behest. Though officially the scrips were in the brokers' names, unofficially KP held them. KP used to cover any losses that occurred due to price shortfall of the scrips and paid a 2.5% weekly interest to the brokers. By February 2001, the scrips held by KP's brokers at CSE were reduced to an estimated Rs 6-7 billion from their initial worth of Rs 12 billion. The situation worsened as KP's Badla payments of Rs 5-6 billion were not honoured on time for the settlement and about 70 CSE brokers, including the top three brokers of the CSE (Dinesh Singhania, Sanjay Khemani and Ashok Poddar) defaulted on their payments. By mid-March, the value of stocks held by CSE brokers went down further to around Rs 2.5-3 billion. The CSE brokers started pressurizing KP for payments. KP again turned to MMCB to get loans. The outflow of funds from MMCB had increased considerably form January2001. Also, while the earlier loans to KP were against proper collateral and with adequate documentation, it was alleged that this time KP was allowed to borrow without any security. By now, SEBI was implementing several measures to control the damage. An additional10% deposit margin was imposed on outstanding net sales in the stock markets. Also, the limit for application of the additional volatility margins was lowered from 80% to 60%. To revive the markets, SEBI imposed restriction on short sales and ordered that the sale of shares had to be followed by deliveries. It suspended all the broker member directors of BSE's governing board. SEBI also banned trading by all stock exchange presidents, vice-presidents and treasurers. A historical decision to ban the Badla system in the country was taken, effective from July 2001, and a rolling settlement system for 200 Group A shares was introduced on the BSE.

The System that Bred these Factors

The small investors who lost their life's savings felt that all parties in the functioning of the market were responsible for the scams. They opined that the broker-banker-promoter nexus, which was deemed to have the acceptance of the SEBI itself, was the main reason for the scams in the Indian stock markets. SEBI's measures were widely criticized as being reactive rather than proactive. The market regulator was blamed for being lax in handling the issue of unusual price movement and tremendous volatility in certain shares over an 18-month period prior to February 2001.Analysts also opined that SEBI's market intelligence was very poor. Media reports commented that KP's arrest was also not due to the SEBI's timely action but the result of complaints by BOI. A market watcher said, "When prices moved up, SEBI watched these as 'normal' market movements. It ignored the large positions built up by some operators. Worse, it asked no questions at all. It had to investigate these things, not as a regulatory body, but as deep-probing agency that could coordinate with other agencies. Who will bear the loss its inefficiency has caused?" An equally crucial question was raised by media regarding SEBI's ignorance of the existence of an unofficial market at the CSE. Interestingly enough, there were reports that the arrest was motivated by the government's efforts to diffuse the Tehelka controversy. Many exchanges were not happy with the decision of banning the Badla system as they felt it would rig the liquidity in the market. Analysts who opposed the ban argued that the Banon Badla without a suitable alternative for all the scrips, which were being moved to rolling settlement, would rig the volatility in the markets. They argued that the lack of finances for all players in the market would enable the few persons who were able to get funds from the banking system - including co-operative banks or promoters - to have an undue influence on the markets.

The People that the System Duped

KP was released on bail in May 2001. The duped investors could do nothing knowing that the legal proceedings would drag on, perhaps for years. Observers opined that in spite of the corrective measures that were implemented, the KP scam had set back the Indian economy by at least a year. Reacting to the scam, all KP had to say was, "I made mistakes." It was widely believed that more than a fraud, KP was an example of the rot that was within the Indian financial and regulatory systems. Analysts commented that if the regulatory authorities had been alert, the huge erosion in values could have been avoided or at least controlled. After all, Rs 2000 billion is definitely not a small amount – even for a whole nation.

The Ketan Parekh scam was an example of the inherently weak financial and regulatory set up in India. Discuss the above statement, giving reasons to justify your stand and discuss the policy amendment made by SEBI after the scam.